MONETARY POLICY IN INDIA

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PREFACE

Money has always been an important factor as it influences vitally the course, nature and volume of economic activities. The importance of monetary policy originates as 'money does not manage itself'. Monetary policy plays a crucial role in managing money and shaping the economic destiny of a country.

This study attempts to make a critical appraisal, from the theoretical as well as empirical plane, of the working of monetary policy in India since the beginning of the Planning era in 1951. With respect of its promotional and regulatory role, the Reserve Bank of India's monetary policy has been oriented to the national objective of economic growth with stability. Though there are various other recognised objectives of monetary policy, yet, looking into the wideness of the subject, they have not been given much emphasis in the present work. The only explanation is, that the subject would have become too wide and difficult to be managed in this size of the work. In fact, in a developing country like India, the objective of monetary stability should be assigned the highest priority in the context of prevailing inflationary pressures. Monetary policy in India is analysed in this study in context of the objective of price stability. This objective can be achieved if the volume, availability and the direction of money and credit in the

economy is controlled effectively and cautiously. Monetary policy is essential to achieve this objective but it alone, however, will not suffice for maintaining growth without inflationary pressures. The solution of the problem lies in the formulation and execution of a suitable anti-inflationary policy through orchestration of various economic policies in the context of India's planning.

The study is both analytical as well as suggestive Structurally, this work is divided into ten chapters. Chapter I sets the study of monetary policy against a wide background. After outlining the origin and concept of monetary policy, the objectives, conflicts and relative importance of various objectives, monetary versus other economic policies and constraints on monetary policy have also been discussed. It has been attempted to indicate in Chapter II that the objective of 'growth with stability' should be the ultimate objective of economic planning in India. It also deals with the meaning of reasonable price stability in India. Chapters III and IV deal with the nature of Indian money market and the role of the Reserve Bank of India in context of the monetary policy since its effectiveness depends, to a greater extent, on the institutional framework within which the monetary policy seeks to function. The subsequent five chapters i.e., Chapters V to IX make a critical appraisal of the functioning and achievements of various tools of monetary

policy in the armoury of the Reserve Bank of India, viz., the Bank rate policy, Open market operations, variable reserve ratios, Selective credit controls and Moral suasion. A detailed discussion about the effectiveness each of these tools of monetary policy, which have been in active use in India for achieving the desired objective of growth with stability, have been done in a separate chapter. Finally, the main observations and conclusions have been incorporated in Chapter X. It also provides guidelines of direction for future.

I express my inestimable debt to Dr. R.K. Dwivedi, Department of Economics, University of Allahabad, under whose supervision the work has been completed. He has taken a keen interest from the very beginning and has guided me throughout the work with constructive suggestions at every stage.

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In the end, I express my sincere regards to my parents and elder brother without whose inspiration and encouragement I could not even think of completing this work.

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ABBREVIATIONS

A.D.	:	Anno Domini 'in the year of the Lord'
art.,arts.	:	article(s)
B.C.	:	Before Christ
ch.,chs.	:	chapter(s)
col.,cols.	:	column(s)
ed.,eds.	:	editor(s)
edn.	:	edition
e.g.	:	exampli gratia 'for example'
et al.	:	et alii 'and others'
etc.	:	et cetra 'and so forth'
ex.,exs.	:	example(s)
fig.,figs.	:	figure(s)
Ibid.	:	ibidem 'in the same place'
i.e.	:	id est 'that is'
no.	:	number
p.,pp.	:	page(s)
par.,pars.	:	paragraph(s)
rpt.	:	reprint
viz.	:	namely
vol.	:	volume
w.e.f.	:	with effect from
&	:	and
Bank	:	Reserve Bank of India
Rs.	:	Rupees in Indian Currency.

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CHAPTER I

BACKGROUND OF MONETARY POLICY

1.1. Origin of Money and Monetary System in India

The discovery of the use of money was an important event in human history. With the use of money, barter or exchange of goods or products against products gave place to exchange of goods and services in terms of money. The use of money introduces a potential threat of managing money. The importance of monetary system and monetary policy arise from the fact that 'money does not manage itself'.

Though the term 'monetary policy' came to be investigated systematically only since nineteenth century onwards, yet in actual practice the monetary policy existed in some crude form since time immemorial. "Earlier writers on money from Plato, Aristotle and Xenophon onward dealt with questions of monetary policy without referring to them as such. Long before their writings practical administrators had taken decisions relating to the monetary system without being aware that they were pursuing monetary policies"[1].

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1. Paul Einzig, Monetary Policy: Ends and Means, rpt.(1964; Middlesex: Penguin Books Ltd., 1967), p.46.
   This book was first published in 1954 under the title How Money is Managed.

The existence of money and several monetary terms in ancient India prove the existence of monetary system and monetary policy at that time. The antiquity of money in India appears to be very great, and is susceptible of being traced backward to about thirty centuries B.C. The proofs of this great antiquity are derived from various sources, which are[1]: (i) the most ancient accounts of the population and condition of society in India; (ii) the code of Manou; (iii) the Vedic writings; (iv) the Buddhic writings; (v) Numismatic and other archaeological remains and (vi) comparative philology.

The populousness and commercial phase of India are proved by ancient writings, Indian remains found at different places and various other sources. At that time India contained a population sufficiently dense and civilized to require the use of money. No large society could long hold together without the agency of money. Such a society which did hold together, must of necessity, have employed money of some sort, and used it as the common means of payment and legal or customary expression of price.

Gold, silver and copper coins are frequently mentioned in the Code of Manou which is one of the most ancient literary monuments of India.

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1. Alexander Del Mar, <u>A History of Money in Ancient Countries</u> (London : George Bell and Sons, 1885), p.58.

The superior antiquity of coined money in India is established by its mention in Vedas, the Sutras of Panini and the Mahabharat. In the Rigveda Sanhita, an allusion is made to purses of gold, purses and lumps of gold are mentioned in a connection that appears to indicate money. The passage seems to refer to stamped lumps of the value of 'suverna'. In another part of the Vedas, allusion is made of 'dinara', a name long used in India for that of a coin or sum of money. From India it made its way to Persia and Arabia as the 'dinara', and to Rome as the 'dinarius'. From the 'dinarius' it became corrupted into the 'denny' and 'penny', for which coin or some of money is still in use in England[1]. The Sutras of Panini, a Vedic work which is assigned to a period ranging from the twelfth to the sixth century B.C., speaks very distinctly of coined money, and derives 'rupya' from 'rupa', i.e., struck or coined. It is from this word that the modern 'rupee' is derived. The Mahabharat makes frequent and unmistakable mention of money, including 'a crore of gold coins'.

The next allusion to money in Indian literature occur in the institutes of Buddha. The age of these scriptures is variously ascribed to periods between the eleventh and sixth centuries B.C. The Buddhist scriptures, in various

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1. Alexander Del Mar, A History of Money in Ancient Countrie[s] p. 64.

places, are full of allusions to money and coins. The 'Sramanas' contain an ordinance forbidding the touching of gold or silver. The 'Vinaya' mentions gold, silver, copper, wooden and lacquer money, the latter being of lac or resin with a figure stamped upon them.

Modern archaeological discovery and research have done much to elucidate the early history of money in India. The antiquity of money in India is confirmed by other ancient writings, by ancient epigraphic monuments and by archaic coins found at different places. It is also confirmed by the existence of 'punched-marked' coins of a purely Indian type, which, though undated, are evidently older than the period of the Greek invasion, and older than Buddhism[1]. The mention of various monetary terms and the names and symbols of 'money' in ancient India tend to prove further that the coined money was in use at that period. The term 'Kasu' corruptly 'cash', means coins, or coined or cast money. Various other monetary terms, viz., 'tankah', 'dehliwala', 'jital' or 'chital', 'dirhems', 'dam', 'mans', 'fanams', 'mudra', 'adalis', 'sicca' and 'mohur' confirm the existence of money and of monetary system in ancient India.

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1. Alexander Del Mar, History of Monetary System (London : Effingham Wilson, 1895), p.2.

The gradual development of money and monetary system through trial and error throughout the ages further gave birth to the monetary policy.

1.2. Meaning And Concept Of Monetary Policy

The term 'monetary policy' has been defined in diffe-fent ways by different economists and policy makers.

According to Geoffrey Crowther, monetary policy, which deals with the monetary system of a country, obviously consists in the steps taken or efforts made to reduce to a minimum the disadvantages of monetary nature which are at least partly due to the existence of money[1].

The above definition depicts that the main function of monetary policy is to regulate only adverse effects of the use of money. But this definition seems to be incomplete.

Paul Einzig appropriately amends this definition by suggesting that monetary policy should be defined as the effort to reduce to a minimum the disadvantages but as well as at the same time to increase the advantages, resulting from the existence and operation of a monetary system[2].

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1. Geoffrey Crowther, An Outline Of Money (London : Thomas Nelson & Sons, 1950), p. 176.
2. Paul Einzig, Monetary Policy : Ends And Means, p. 48.

But, both of these definitions are concerned mainly with the objectives of monetary policy rather than its nature. Moreover, both the definitions suggest that the monetary policy deals only with the monetary steps and objectives.

However, the above definitions are too limited to cover the entire field of the monetary policy. In its wider sense, the term 'monetary policy' includes "all monetary decisions and measures irrespective of whether their aims are monetary or non-monetary, and all non-monetary decisions and measures that aim at affecting the monetary system"[1].

This definition covers a broader sphere of monetary policy. Under this definition, monetary as well as non-monetary measures which are taken for achieving irrespective of either monetary or non-monetary (economic, social or political) goals, come under the scope of monetary policy. This definition includes monetary measures taken for influencing the value, volume, etc. of money as well as non-monetary steps like control of prices or wages, physical controls, budgetary devices, export promotion or import restrictions, measures of employment promotion or quota

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1. Paul Einzig, Monetary Policy : Ends and Means, p. 50.

system would be included under monetary policy in so far their primary objectives is to influence the monetary situation in a country.

The very first chapter of the Radcliffee Committee Report[1] also opens with the similar and more compact following interesting observations on monetary policy:

"Monetary policy is necessarily moulded by the world in which it takes shape. The scope for its exercise is not invariable, and the aims which it is intended to serve, the resolution with which it is applied, and the techniques which give it effect are all conditioned by the facts of the economic situation and the ideas of the time"[2].

The above description which shows that monetary policy is a moving factor, throws sufficient light on its nature, contents and importance. But it should also be noted that monetary policy of a country is not an independent entity in

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1. Report of the '<u>Committee On The Working Of The Monetary System</u>', headed by Lord Radcliffee as Chairman, was presented to the Parliament of England by the Chancellor of the Exchequer by Command of Her Majesty in London in August 1959, contains 986 pars., pp. viii + 375, is known as Radcliffee Committee Report. Referred to hereafter as <u>Radcliffee Committee Report</u>.

2. <u>Radcliffee Committee Report</u>, par. 17, p.6.

itself but an important aspect of overall economic policy[1].

According to C.R. Whittlesey, "Government exists largely for policy and all policy is an expression of the act of governing. Economic policy, in turn, is a division of public policy. It relates, obviously enough, to policies directed towards economic — as contrasted with military, political or social-ends. It embraces a wide range of sub-policies, wages, tariffs, transportations, exchange control, agriculture. One of these subdivisions is monetary policy"[2].

Hence, the Government and the central banking authorities play major roles in its formulation and implications. In fact, monetary policy is a particular form of economic policy evolved by the central bank in collaboration with the State to suit the economy of a country[3].

Therefore, it can be said that monetary policy, as an aspect of the State's intervention in the economic process, includes the policy measures that can be applied by the central bank as a central monetary authority of the country.

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1. V.G. Pendharkar and M.Narsimham, "Recent Evolution of Monetary Policy In India", Reserve Bank of India Bulletin, April, 1966, p.340.

2. C.R. Whittlesey, Lectures On Monetary Management (Bombay: University of Bombay, 1960), Series in Monetary and International Economics, No.1, p.9.

3. K.K. Sharma, India's Monetary Policy, (Meerut : Meenakshi Prakashan, 1968), in Preface.

Therefore, "in its broadest sense, monetary policy includes all actions of Governments, central banks, and other public authorities that influence the quantity of money and bank credit....A few even extended the meaning of monetary policy to include official actions affecting not only the quantity of money but also its rate of expenditure, thus embracing government tax, expenditure, lendings, and debt management policies"[1].

It has become customary, however, to define monetary policy in a more restricted sense and exclude from it choices relating to the broad legal and institutional framework of the monetary and banking system. Under this description, monetary policy may be defined as "the management of the expansion and contraction of the volume of money in circulation for the explicit purpose of attaining one or more objectives....in a broad sense, monetary and banking regulations of all varities are expressions of monetary policy, since they are influential in controlling the volume of money available throughout the economic system"[2]. Paul A. Samuelson also defines it in the same manner. He says that by monetary policy, we mean primarily

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1. International Encyclopaedia Of The Social Sciences, ed. David L. Sills (New York : The Macmillan Company & The Free Press, 1972), Vol. 9, p.419.

2. Raymond P. Kent, Money And Banking, rpt. (New York : Holt Rinehart and Winston, 1966), p. 522.

central bank's actions designed to affect the tightness and easiness of credit conditions and the behaviour of the total supply of money and near money substitutes[1]. Harry G. Johnson has also defined monetary policy as a "policy employing the central bank's control of the supply of money as an instrument for achieving the objectives of general economic policy"[2].

While in the developed economy, the monetary policy is mainly concerned with its regulatory aspect, but in a developing economy, the monetary policy has to facilitate economic growth on the one hand and to restrain inflationary pressures on the other. It has, thus, to be a policy of 'controlled expansion'. Therefore, monetary policy in a developing economy has to be used with a view to regulate the expansion of money supply in consistance with the economic growth and steady price level. The cost, availability,

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1. Paul A. Samuelson, "Money, Interest Rates and Economic Activity : Their Inter-relationship in a Market Economy" in <u>Monetary Economics : Readings On Current Issues</u>, eds. William E. Gibson and George G.Kaufman (New York : McGraw-Hill Book Company, 1971), p.55.

2. Harry G. Johnson, "Monetary Theory and Policy" in <u>Monetary Theory And Policy : Major Contributions to Contemporary Thought</u>, ed. Richard S. Thorn (New York : Random House, 1966), p. 5.

quantity and distribution of money are, therefore, mainly concerned with the monetary policy in India. Therefore, monetary policy, in the present context, refers to those decisions of the Reserve Bank of India which directly or indirectly determine the quantity of money, the structure of interest rates and the distribution of bank credit among various users and purposes[1].

For the purpose of the present study, therefore, the monetary policy is defined or the control of availability, cost and the use of money and bank credit with the help of various monetary instruments to achieve the desired objectives.

1.3. Objectives of Monetary Policy

This is a significant feature of monetary policy that the scope and content of its objectives keep on changing from country to country and from period to period, depending on the stage of development, structure and nature of economy of the country[2], or even as a result of a change in the fashion of thinking[3]. The objectives of monetary

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1. C.K. Johri, Monetary Policy in a Developing Economy (Calcutta : The World Press Pvt. Ltd., 1965), p.235.

2. The Reserve Bank of India, Functions and Working, rpt. (Bombay : Reserve Bank of India, October, 1970), p.4.

3. Paul Einzig, Monetary Policy : Ends and Means, p. 66.

policy are many and various, and may vary even in the same country at different times. Apart from the various objectives, emphasis and choice of alternative objectives are also liable to shift from a developed country to an underdeveloped country quite differently.[1]

Since the monetary policy of a country is an important part of its overall economic policy, its objectives must also be regarded as being part of overall objectives of economic policy[2]. This is the reason, that, when economic objectives are set, it is expected that the monetary policy should aim at achieving certain objectives determined by the monetary authorities. But, for the formulation of the appropriate monetary policy, "while it is imperative that, its objectives should be clearly specified, it is not easy to develop the objectives of national policy which are always mutually consistent"; and on the other hand, "it is even more difficult to develop" appropriate monetary policies" to accomplish these objectives[3].

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1. Alvin, H. Hanien, Economic Issues of 1960's (New York : McGraw-Hill Book Co., 1960), p.167.

2. V.G. Pendharkar and M. Narsimham, "Recent Evolution of Monetary Policy in India", Reserve Bank of India Bulletin, April 1966, p. 340.

3. Sid Mittra, A New Horizon in Central Banking (Bombay : Asia Publishing House, 1967), p. 133.

Whatever may be the case, even then it is evident that though the urgent problems of the economic policy of a nation are ever changing and its objectives vary from one country to another, there is a spectrum of objectives, unique in each case that a country can adopt.

Monetary objectives, it seems, move with time along with the changes in economic circumstances. The objectives of monetary policy have undergone a change since its origin. During the period of international gold standard, "the dominant and overriding objective of monetary policy in the various gold standard countries was to maintain the convertibility of the national currency directly or indirectly into gold at the legal parity, i.e., to maintain approximately fixed exchange rates against other gold currencies"[1]. The objective moved then towards financing the Government. Later, it shifted to the maintenance of the level of prices. During the nineteen-thirties, the objective was to maintain full employment and output, and thereafter to maintain balance of payments equilibrium. After the Second World War, the objective of monetary policy has been directed towards accelerating economic development.

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1. Arthur, I. Bloomfield, Monetary Policy Under The International Gold Standard : 1880-1914, Monograph (New York: Federal Reserve Bank of New York, October, 1959), p.23.

The Radcliffe Committee examined the working of the monetary policy and has given a list of a new set of objectives, which are more applicable in present context rather than those had already been given by the Macmillan Committee[1]. The Radcliffe Committee[2] had listed the objectives of monetary policy as :

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1. The Report of the Committee on Finance And Industry, (Macmillan Committee), 1931, pars. 280 to 282.
   The list of objectives given by the Macmillan Committee was:
   'Maintaining the parity of the foreign exchange without unnecessary disturbance to domestic business'.
   'The avoidanse of the credit cycles'
   'The stability of the price level'
   'The stability of output and employment at a high level'.

2. The Radcliffe Committee prepared its Report under different set of circumstances, than those of Macmillan Committee. The Report of the Radcliffe Committee says, "The world of 1959 is far removed, both in economic climate and in intellectual atmosphere, from that in which the Macmillan Committee prepared its Report thirty years ago. We have found it useful, in considering how the monetary system now works, to review the changes that have occured since that Report was issued".
   Radcliffe Committee Report, op.cit., par. 17, p. 6.

"(1) A high and stable level of employment.

(2) Reasonable stability of the internal purchasing power of money.

(3) Steady economic growth and improvement of the standard of living.

(4) Some contribution, implying a margin in the balance of payments, to the economic development of the outside world.

(5) A strengthening of London's international reserve, implying further margin in the balance of payments"[1].

The presentday objectives of monetary policy, which are commonly accepted in various developing countries are, however, more or less similar.

On the eve of economic planning, India was faced with complicated economic problems. They were the results of political and social enviroment and the attitudes of the people. In this context, development policy consisted in creating favourable circumstances and attitudes for economic growth. This is the recognition that provided the rationale to planning in India.

Basically, Indian economic planning has economic and social objectives, namely, the expansion of output, income

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1. <u>Radcliffe Committee Report</u>, par. 69, pp. 22-3.

and employment and reduction in inequalities of wealth and incomes. These were the principal objectives of all the Plans. All these objectives were to be achieved without hampering price structure.

Now, in the Indian context, it will be useful to explain the importance of various economic and social objectives which monetary policy is directed to achieve.

1.3.1. Maximizing Economic Growth

The paramount aim of economic policy of any country is, naturally, the welfare of its people. Therefore, the fundamental objective of economic policy in various developing countries including India is maximization of economic growth with stability. In specific terms, this means the promotion and maintenance of a rising level of production and real national income and the attainment of reasonably full-employment[1], by adequate utilization of all available resources (like raw materials, machines, labour and technical know-how), so that the people may achieve ever higher standard of living by ever higher rate of production and consumption of material wealth and ever increasing level of employment.

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1. C.R. Basu, Central Banking in a Planned Economy : The Indian Experiment (1971; Second ed. New Delhi : Tata McGraw-Hill Publishing Company Limited, 1978), p. 127.

Following the phrase of 'higher the economic growth, higher will be the standard of living', it is generally argued that even a high level of output today is not enough, unless it is higher than what it was yesterday[1]. It has been recognised now that the rate of growth of a nation's material resources can increase, if the government takes some proper economic steps. But, mere increase in resources is not enough for meeting the goal of stable economic growth. More essential factor is the suitable and effective manipulation of monetary policy; because the most of the developing countries do not face lack of resources as the main problem in the way of development, but it is the problem of their effective mobilization and efficient allocation[2] in various channels of the economy. Therefore, only when a country recognises the limitations as well as potentialities of monetary policy, it will be able to develop a balanced overall programme for promoting economic growth, and place proper stress on many other measures necessary to achieve the ambitious objective of furthering the stable economic growth[3].

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1. Walter W. Haines, Money, Prices and Policy (New York : McGraw-Hill, 1961), p. 560.

2. P.C. Bhattacharya, "Monetary Policy and Economic Development", Reserve Bank of India Bulletin, February, 1966, p. 122.

3. Lester V. Chandler, Central Banking And Economic Development (Bombay : University Press, 1962), p.54.

1.3.2. Maximising The Total Employment

Another important objective of economic policy which has been developing rapidly in recent years, is maximising the total employment. In the earlier years of planning in India, maximisation of employment was not considered to be an important objective in itself, but was looked upon as a 'by-product' of the economic growth[1]. But now it has been clearly felt that in most of the developing countries like India, which are primarily agricultural and over-populated, the problems of huge unemployment, under employment and disguised-employment lead to hinder the process of development. So, the objective of employment creation upto

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1. It was clearly stated in the First Five Year Plan that full-employment was not an end in itself and should be regarded as a corollary of development rather than as a direct objective. Even in the Second Five Year Plan which placed relatively more emphasis on the creation of gainful employment opportunities, it was recognised that the problem of unemployment especially in an under-developed country like ours could be solved after a period of intensive development. The same viewpoint of treating employment as a by-product of development persisted among the planning elites in the country even during the Third Five Year Plan period when the problem of open unemployment had become acute. It was felt that the achievement of other goals of economic policy would automatically lead to a larger expansion of employment opportunities, which in turn, would raise the standard of living of the people.

the level of full-employment is of great importance[1]. John Maynard Keynes has pointed out that full-employment is not at all an automatic derivative of the market economy. If a competitive economy is left to take care of itself, normally it would be unable to reach the point of full-employment, because the freeplay of self-generating market forces might not only prevent the economy to meet the objective of full employment, but they might also deteriorate the employment situation and compel it to revert to situations of increasing unemployment. Thus, Keynes emphasized the necessity for active and conscious intervention of the central and monetary authorities with the free-play of natural market forces which may need to be curbed or guided by taking most efficient measures, so that the economy could have advanced towards the point of full-employment[2], which is desirable from social, political as well as economic viewpoints[3].

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1. "....many countries have now recognised the expansion of employment opportunities as one of the major aims of development planning and several countries, such as India and Morocco, which had already set out employment targets or implications in their development plans, are endeavouring to create more employment than was provided for in the Plans." International Labour Office, Employment And Economic Growth (Geneva : International Labour Office, 1964),p.130

2. John Maynard Keynes, The General Theory of Employment Interest And Money (London:Macmillan & Co.Ltd.,1946),pp.379-80.

3. Jitendra Dholakia considers that maximisation of total employment would contribute to (i) income generation and more equal personal and regional income distribution; (ii)increase in production; (iii) increasd in saving, because the maintenance of the unemployment in any case eats into the savings of the employed. Jitendra Dholakia, Unemployment And Employment Policy in India (New Delhi: Sterling Publishers Pvt. Ltd., 1977), p. 41.

Therefore, fulfilment of the full-employment objective is considered to be dependent upon the skill and open-mindedness of the monetary authorities to choose and adapt the delicerate measures and use the appropriate technique of central banking system to the ever changing economic situation of the country.

1.3.3. Stabilising The Internal Price Level

Next and perhaps rather more important objective of economic policy is stabilising the internal price-level. The need for maintaining a stable price level, in the context of a developing economy with a 'Welfare State' as the goal is generally emphasised. While increased public expenditure on schemes of economic development in such an economy is a helpful means of securing a larger national product, the keeping under control of an uptrend in the price structure is a pre-requisite for ensuring better distribution and enjoyment of the fruits of economic development. Further, the fall in purchasing power of money also reduces the rate of interest and value of money in real terms and creates disincentive for saving and induces people to spend their resources in luxurious unproductive items. Constantly rising prices further lead to a flight of money abroad and discourage an inflow of capital and, thus lead to a worsening of country's international position. "External

stability is thus a reflection of internal stability"[1].

What is required, therefore, is the stability in the prices of basic consumption goods. If the price level of consumption goods is allowed to increase, that results an understandable demand on the part of labour for a neutralization of the price rise by a corresponding rise in wages and salaries, which in turn, leads to a wage-push inflation and sets in motion the dreaded inflationary spiral which is suicidal for an economy that embarks on planned development[2]. In such an economy investment, both for public and private sectors, and targets to be achieved have to be planned by the State in advance, and these will become merely guess-work in the absence of price stability. This, in turn, will seriously undermine people confidence in the country's economic plans.

Price stability, therefore, becomes the prime objective of country's overall economic policy. "The role of the monetary policy in a developing economy is to achieve a

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1. K.K. Sharma, Role of Monetary Policy in Planned Economy With Special Reference to India (Meerut : Meenakshi Prakashan, 1965), p. 34.

2. Suraj Bhan Agrawal, Price Trends in India : Since 1951 (Bombay : Somaiya Publications Pvt. Ltd., 1978), p. 190.

reasonable degree of stability of the general price level to enable the overall economic policy to ensure steady growth"[1]. Monetary policy has a positive role to play in this context. A suitable monetary policy is an essential base of an appropriate price policy. In recent times, due to the continuous prevailing inflationary spiral in economy, the importance of attainment of price stability has increased so much in the Indian context, that nowadays it has considered to be the paramount objective of Indian monetary policy.

1.3.4. Maintaining Stability of the Exchange Rates

Another important objective of economic policy, from the point of view of a developing country, is maintaining stability of the exchange rates. Since most of the developing countries depend upon international trade for the development of their domestic economic situation, external value of currency or exchange rates are of decisive importance for the various components of a country's trade and balance of payments with the outside world[2]. Thus with any unfavourable fluctuation in exchange rates of currency, there will be

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1. A.B. Ghosh, Price Trends And Policies in India (Delhi : Vikas Publishing House Pvt. Ltd., 1974), p.6.

2. Egon Sohmen, Flexible Exchange Rates (Chicago : The University of Chicago Press, 1969), p. 3.

disequilibrium in country's trade and balance of payments. And as the result, therefore, not only heavy burden of foreign exchange deficit will arise, but also there will other unfavourable reactions on domestic price-levels, growth and employment positions[1].

The domestic monetary situation may become more worsen and quite dangerous in absence of anti-inflationary measures. "Uncontrolled inflation and a free exchange rate may quickly lead to hyperinflation, with disastrous consequences to the economy"[2]. Flexibility of exchange rates, on the other hand, helps stronger currencies against the weaker ones - and unfortunately, most of the developing countries like that of India, have weak currencies[3]. Therefore, the objective of exchange rates stability, is of great importance for the maintenance of domestic and international confidence and the conduct of international trade on the largest possible scale, which in turn is considered to be one of the prime requisites for the maximum economic

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1. "....rise or fall in the exchange rate is liable to react on the internal monetary situation". Paul Einzig, Monetary Policy : Ends and Means, p. 354.

2. Raymond F. Mikesell, Foreign Exchange In Post-War World (New York : The Twentieth Century Fund, 1954), p. 159.

3. A.K. Sengupta,"How Far a New Economic Order ?", Span, January 1979, p.7.

welfare of the world[1]. The monetary policy may be used effectively to meet the objective of maintaining stability of the exchange rates to a great extent by means of various devices applied to the internal monetary position and the foreign exchange situation, which are liable to react on exchange rates[2].

1.2.5. Equitable Distribution of Income

Another important objective of economic policy in Indian context, is the fairer and equitable distribution of income and wealth amongst the various classes of people of the nation. The Constitution of India has also stated the desirability of attaining certain socially just objectives, namely: (i) reduction in concentration of economic power and thereby preventing opportunities for exploitation; (ii) reduction in inequality in distribution of wealth, and (iii) provision of minimum livelihood for everyone[3]. These ideals of fairer distribution are of paramount importance for any progressive economy. Economic development with

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1. M.H. De Kock, Central Banking, rpt., (1939; London : Crosby Lockwood Staples, 1976), p.128.

2. Paul Einzig, Monetary Policy : Ends and Means, p.354.

3. K.N. Bhattacharyya, India's Fourth Plan : Test In Growthmanship (Bombay : Asia Publishing House, 1966), p. 67.

social justice is a noble pursuit. But it is rather shocking to see that in India, the disparity of income, far from getting narrower, is becoming wider[1]. This is due to the fact that "the small gains of development seem to be monopolised by the upper middle and richer sections of the society leaving the lower middle and poorer sections more or less untouched by the process of development"[2]. This sort of unequal distribution of income and wealth clearly permits the concentration of economic power in a few hands, which makes poor comparatively poorer and increases poverty. Therefore, it must be noted that poverty and income inequalities are interconnected, and to remove former the latter can not be overlooked. For these reasons, in recent time social, political, economic thinkers and others who advocate the objective of human welfare have started giving proper emphasis on equitable manner of distribution. India, in her liberal democratic framework, can very well pursue the attainment of this humane objective, by applying proper measures of economic policy, vis-a-vis, monetary policy.

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1. Several studies have been done in India regarding this problem. Some of the studies are those of Burdhan, 1970; Dandekar and Rath, 1971; Mandiwo, 1971; Vaidyanathan, 1971; Ojha-Bhat, 1976; Ahmad and Bhattacharya and the Indian Institute of Public Opinion, New Delhi, 1976.

2. V.M. Dandekar and Nilkanth Rath, Poverty in India (New Delhi: Indian School of political Economy, 1971), p.64.

1.4. Conflicts And Relative Importance of Various Objectives

Having examined their nature, now it is clear that monetary policy can be directed toward achieving many different objectives. It is evident that the monetary authorities have to recognise several objectives, but in actual practice that introduces a possibility of conflict between these specific objectives.

It is obvious that in aiming at any particular objective, a number of difficulties will crop up for the monetary authorities, due to such conflicting nature of these multiple objectives. To a large extent, most ends of monetary policy are liable to overlap with other ends. For example, in a developing economies the objective of maximising economic growth may conflict with the objective of price stability. In achieving the projected rate of economic growth, the prices will have to rise because entrepreneures should be provided with the intensive of increasing their profits by raising the prices. "The rationale of a policy of 'development through inflation' is that inflation raises the ratio of profits to national income so that the inflationary process continues until profits increase so much that businessmen can finance the higher rate of investment from the savings out of their profits without any further recourse to monetary

expansion"[1]. This argument is based on the assumption that the marginal propensity to save out of profit is relatively large than that of our of wages. In such situation, it is perhaps not possible to attain both together - the objective of economic growth and the objective of price stability at same time. Therefore, if monetary policy aims at achieving the economic growth it may have to undermine the objective of stability of price level to that extent.

It is also impossible to achieve the objective of economic growth simultaneously with the objective of equitable distribution of wealth and income upto some extent. A greater equality of incomes might lead to an inadequate supply of saving, which, in turn, retards the progress of economic growth, because people with high incomes save a large portion of their income, and people with low incomes only save a nominal portion. Therefore, the more unequal distribution of incomes leads to greater total saving and economic growth[2]. Keynes has also argued

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1. Santikumar Ghosh, Inflation In An Underdeveloped Economy : A Study Of Inflation In India (1959, Calcutta: The World Press Private Ltd., Second Edn., 1964), p.20.

2. Leif Johansen, Public Economics (Oxford : North-Holland Publishing Company, 1975), p. 300.

in favour of inequal distribution of incomes for maximising economic growth[1].

The objective of equitable distribution of incomes also makes it difficult to maximise total employment. There is social justification if more income goes to the profit earning entrepreneurs rather than to the consumers and wage earners, since with higher incomes profit earners will, to that extent, be able to step up rate of investment and consequently employment. Therefore, if monetary policy sticks to the objective of equitable distribution of incomes by redistributing it properly in favour of the poor, such redistributive policy may reduce the national saving and hence investment and total employment.

A.W. Phillips, with his well-known 'Phillips Curve' has shown that there are cases of conflict between price stability and attainment of full employment and, therefore, there is need for a trade off between the rate of change of prices and unemployment rate. 'Phillips Curve', which depicts the relationship between wage changes, price changes and the unemployment rate, shows that both the objectives,

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1. In words of Lord Keynes, "For my own part, I believe that there is social and psychological justification for significant inequalities of income and wealth...." John Maynard Keynes, The General Theory of Employment, Interest And Money, p. 374.

price stability and full employment cannot be attained at the same time[1].

It is also argued that the level of full employment can not be permanently maintained without bringing the inflationary spiral into play[2]. Thus, the situation may arise in which actions directed to attaining the objective of full employment will be conflicting with the pursuit of the objective of stable price levels. And if it is tried to stop inflation by shutting off the flow of increasing purchasing power, this, in turn, may not only stop price increases but may also reduce output and lead to unemployment. In this way, the objectives of full employment, price stability and economic growth also clash with each other.

The above discussion was related to possible conflicts among a nation's various domestic objectives. One or more of these domestic objectives may also conflict with the nation's international objective of maintaining a stable

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1. A.W. Phillips, "The Relation Between Unemployment And The Rate of Change Of Money Wage Rates In United Kingdom: 1861-1957", Economica, Vol. 25, November 1958, pp.283-99.

2. J.L. Hanson, Monetary Theory And Practice (London : The English Language Book Society And Macdonald & Evans Ltd. Fifth Ed., 1974), p. 222.

exchange rate of its currency. An expansionary monetary policy, aimed to increase domestic demand and eradicate excess unemployment would tend to widen the deficit in the nation's balance of payments; while a restrictive monetary policy, aimed to check domestic inflation and to eradicate the deficit in its balance of payments would increase unemployment at home. Therefore, the nation may be forced to sacrifice its domestic objectives relating to employment, output, stable prices and growth or to increase or lower the exchange rate of its currency.

Now it is clear that one of the most basic problems of monetary policy relates to the possibility of conflict among various agreed-upon policy objectives. The problem becomes more critical, as the conflict may even be between the same objective at different points of time, e.g., a policy of promoting full employment in the immediate future may be an obstacle to full employment later[1].

Conflicts between various objectives and clashing arguments about relative importance of one or another end of monetary policy makes the situation more confused and critical. Government in fact have a large number of

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1. Jagdish Bhagwati, The Economics Of Underdeveloped Countries (London : World University Library, Weidenfeld and Nicolson 1971), p. 107.

objectives, but only a few of them can be simultaneously achieved. It is very difficult for any economy to attain completely all of these objectives except by sheer coincidence[1]. Moreover, these objectives of economic policy to which monetary policy is related, are complex and not easily reconcilable with each other. This is only by taking into account the prevailing circumstances in the economy, monetary authorities have at times to give priority to various goals for which monetary measures are being taken. But, the actual problem begins when the promotion of some ends are favoured against others. The Radcliffe Committee has also recognised that there are serious possibilities of conflict between these objectives, and further clarified that the freedom of Government in making these choices was not absolute, but was limited by the importance of each of these objectives to the continuous and orderly life of society[2].

Many differences of opinion on matters of monetary policy are caused by disagreements about the relative importance of ultimate ends. Thus, for those who think

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1. S.R. Basu, Central Banking in a Planned Economy : The Indian Experiment, p. 127.
2. Radcliffe Committee Report, para 70, p. 23.

that greater equality of incomes and wealth is more important than a maximum rate of economic growth, will naturally disagree with those who would give first priority to growth rather than equal distribution. And those who believe that extreme level of full employment is desirable, not only for its own sake, but also because they think that rapid economic growth is possible only with some degree of inflation, will differ from those who believe that inflation is not only totally unjust in its effects, but also leads to the inefficient managements, and thus in long run tends to slow down the rate of growth[1]. For those who believe that price stability is more important rather than employment, they may risk greater rates of unemployment for the sake of relatively stable prices.

Because of such conflicts and differences of opinion about relative importance of ultimate various ends of monetary policy, the problem of choosing targets arises, Richard S. Thorn gives a very interesting example in his work entitled 'Introduction to Money and Banking', by comparing the problem of multiple objectives with a juggler's balls, and

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1. F.W. Paish, "Unemployment and Price Stability", in <u>Inflation</u>, eds. R.J. Ball and Peter Doyle, rpt. (1969: Middlesex : Penguin Books Ltd., 1972), p. 219.

showing similarity between them. He writes that the problem of achieving various goals of monetary policy is similar "....to the problem of a juggler who wants to keep a large number of balls in the air but has only two hands with which to achieve this. Certain goals are given priority in their attainment, and as progress is made in reaching them priority is redirected so that available economic instruments are used to achieve other goals. Just as a juggler keeps many balls in the air, some going up, some going down, so it is possible to make progress in achieving many economic goals - though some will be attained at a faster rate than others. The role of policy makers under this strategy, then, is to identify the priorities of the goals and to constantly reorder them as progress is made towards achieving them"[1].

The conclusion drawn from the above discussion is that the problem of monetary policy therefore centre on choosing targets[2] and establishing their priorities...."The problem

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1. Richard S. Thorn, Introduction To Money And Banking (New York : Harper And Row, 1976), p. 225.

2. "...a policy decision has to be taken by the public authority whether to pursue one or the other or which combination of two has to be accepted." B.Misra, Economics of Public Finance (Delhi : The Macmillan Company of India Limited, 1976), p. 183.

is not merely one of choosing or setting any one objective; but ensuring co-ordination and consistency among different objectives...."[1], because any attempt to push too far one objective at the cost of another may cause intolerable strain to the body politic and may even disrupt society. It is, therefore, necessary to decide carefully and wisely on the appropriate 'mix' among the objectives of monetary policy in a country, according to the needs, phasing and character of its economic development, in a manner to maximise the welfare of the community. The welfare of masses is not a precise objective and must be translated into a relatively small number of more precise sub-objectives in order to effectively guide monetary policy.

The importance of achieving 'growth with stability', which has become the most important objective in Indian context, has been discussed in next chapter.

1.5. Monetary Versus Other Economic Policies

As explained earlier, monetary policy is an integral part of its overall broader economic policy of a country and normally there should not be any conflict between them.

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1. B.D. Ghonasgi, "The Monetary Policy in a Developing Economy", in Monetary Policy and Central Banking in India, eds., V.R. Mutalik Desai and B.D. Ghonasgi (Bombay : Popular Prakashan, 1969), p. 149.

Monetary policy is not the only established instrument of aggregate economic policy as it was supposed to be before 1930's, when price stability was its established objective. Now, it has to work amidst various other instruments of economic policy, viz., fiscal policy, public debt policy, incomes policy, wage policy, import and export policy, and international monetary policy.

The availability of these various alternative policy instruments introduces the question of relative importance, choice and effectiveness.

It has been observed that fiscal policy is often considered as a more important determinant of aggregate demand than monetary policy. Both monetary and fiscal operations have repercussions on the whole economy, affecting various economic factors. While monetary policy influences economic trends, especially inventory investment through the cost and availability of credit; fiscal policy, in contrast, effects directly the financial resources and purchasing power in the hands of the public through use of a variety of income and commodity taxes. Again, in a country which has adopted a programme of planned economic development, in which the public sector has an important part to play, fiscal policy would be concerned largely with effecting structural changes in the economy, while monetary policy

would be aimed at regulating investment in the private sector and the short-run management of the economy[1]. Also, the capacity of taxation, for example, to differentiate among the circumstances of different classes of producers and consumers through reliefs and rebates and investment allowances of various kinds or through commodity taxes is much greater than of central bank action through allocation of bank credit. These conclusions held generally, and the role of monetary policy should be recognised as subsidiary or subordinate to fiscal policy[2].

But, monetary policy is still relatively more significant due to various other factors.

A factor which increases the significance of monetary policy in Indian conditions relates to the money supply, which is powerfully influenced by the Government decisions of the development programmes. The credit for the public sector like that of private sector is ultimately created by the central bank. Central bank action is, however, endowed

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1. Reserve Bank of India, Functions and Working, pp. 33-34.
2. B.K. Madan, The Role of Monetary Policy in a Developing Economy (Chandigarh : Punjab University Publication Bureau, 1963), p. 22.

with a peculiar influence over credit for the private sector, which falls within the special domain of monetary policy[1].

The significance of monetary policy is also rising with the expanding banking network in the country. While the effectiveness of fiscal policy decreases considerably with the wide tax-evasion, the effectiveness of monetary policy is increasing with expansion of banking facilities in all parts of the country and the banking habits of the people. Inadequate development of other financial institutions like finance houses, higher purchase companies, etc. also makes for a large influence for commercial bank lending and correspondingly for monetary or central bank policies. Greater dependence of commercial banks on central bank credit also enhances the greater ability of the Reserve Bank to influence the credit policies of banks, which ultimately increases the effective range of monetary policy.

Some more relevant considerations bearing on the scope of monetary policy in general may be set out at this stage.

The task of the monetary policy is enhanced as it has the responsibility of freezing part of the liquidity as increased Government expenditure on developmental programmes

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1. B.K. Madan, The Role of Monetary Policy in a Developing Economy, p. 24.

generate strong inflationary pressures. Fiscal operations create income through disbursal of wages and salaries, purchase of goods and other payments all over the economy, while monetary policy works direct through restricting the ability of enterpreneurs to borrow for expanding their operation. In effect, since monetary policy can mainly restrict expansion of economic activity only in private sector, stringent use of such policy restrains growth in the private sector without affecting the investment pattern in the public sector. But, at the same time, it must be recognised that in some of its aspects the influence of monetary policy not only permeats the activity of the private sector but, in a democratic setup, extends to the functioning of public sector activity itself[1].

Monetary policy has a more significant role in comparison with fiscal policy due to its structural characteristics which enable it to be used continuously throughout the year. While fiscal policy can be brought into play only at infrequent intervals and it has to go through various parliamentary processes; techniques of monetary policy, on the other hand, may be adjusted skillfully within no time depending upon the decisions of monetary authorities

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1. Alka Agrawal, Interdependence of Monetary and Fiscal Policies (Allahabad: Kitab Mahal, 1972), p. 242.

according to the tempo of economic weather and climatic shifts in the economy.

The above discussion brings out the importance of both monetary and fiscal policies. The growth of national budgets raised fiscal policy to a status equal to that of monetary policy. But, the monetary policy has a significant role to play in the context of economic planning due to its immediate effects and sectoral sensitiveness.

The Government has wide powers to its command to regulate, promote and direct the economy through various other policy measures also, such as public debt policy, incomes policy and wage policy.

Growth of public debt has raised the status of policy of debt management, but not to a level quite so high as of monetary policy[1]. Public debt policy is a powerful source of financing Government. This leads to expansion in money supply and allows the Government to carry the large scale investment programmes. Therefore, unless this sort of financing back of public borrowing programme is controlled properly, monetary policy cannot work effectively.

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1. C.R. Whittlesey, <u>Lectures On Monetary Management</u> (Bombay: University of Bombay, 1960), p. 17.

Incomes policy and wage policy are also yet other policy measures of aggregate economic policy. The latter aims at regulating the rate of increase of money wages in an economy. It usually involves direct Government intervention in the establishment of a desired wage level. The incomes policy, on the other hand, would imply a restraint in the rise of not only money wages but also other income sources like rent, profits and dividends[1]. Therefore, these policies also considerably influence the consumption, savings and investment conditions.

Incomes policy also works as an effective instrument to combat demand-pull inflation. When there is a demand-pull inflation, i.e., when aggregate real demand is in excess of the supply potential of the economy, the suggested policy measures, whether monetary policy or fiscal policy designed to contain inflation may have very little favourable impact on the situation and may even have adverse effects on output and employment in the economy, the cure suggested in the implementation of an incomes policy[2].

The above discussion leads to the conclusion that there are various policy measures having their own individual

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1. B.S.R. Rao in <u>Inflation in India</u>, ed. S.L.N. Simha (Bombay : Vora & Co, Publishers Pvt. Ltd.,1974), p. 261.
2. B.S.R. Rao in <u>Inflation in India</u>, ed. S.L.N. Simha, p.262.

importance in overall economic policy. But, the relative importance of these policies, however, is not the significant thing as the use of one policy or the other may be more important at different times and different economic circumstances. Therefore, these policies must not be treated as competitive. The measures of monetary policy will become more effective and meaningful if these policies are taken into account carefully because they have significant monetary significance[1]. This is essential that the various instruments of overall economic policy must be exercised in a co-ordinated manner. This is essential in order that one instrument does not interfere with or offset the effects of another. It is also in order that a particular method can be employed for the special purpose for which it is best adapted. A proper combination of these policies is necessary to achieve the desired goal. Monetary policy as a whole must be properly co-ordinated with fiscal policy and debt management. Correct monetary policy can no doubt undo some of the harm of faulty fiscal policy and debt management[2]. This is necessary to provide greater strength to the working of monetary policy. This policy 'mix' can be appropriately adjusted according to the environmental factors and need of the economy in each case.

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1. T.R. Manaktala, Economic Development and Monetary Management in India (Bombay:Vora and Co. Pvt.Ltd.,1966), p.23.
2. C.R. Whittlesey, Lectures On Monetary Management, p.83.

1.6. Constraints On Monetary Policy

Although monetary policy has received wider recognition and attention at the hands of economists and policy makers for its merits, still there are some constraints which set a limit to its overall effectiveness. It is apparent that such constraints are larger in number in a developing economy as compared with those in a developed economy.

The effectiveness and success of the monetary policy to a great extent depends upon the quickness of policy actions and the quickness of response of the economy. But the effectiveness and quickness of monetary policy in India a limited due to various lags which it suffers. There are three recognised lags[1] working as constraints on monetary policy, namely (i) the recognition lag (the interval between the time when a need for action develops and the time the need is recognised), (ii) the administrative lag (the interval between recognition and actual policy action), and (iii) the operational or impact lag (the interval between policy action and the time that the policy objectives respond fully).

Sufficient attention has not been paid to all these lags which generate quite long unwanted time during policy implications and, therefore, conceivably put the monetary

1. International Encyclopaedia of the Social Sciences, ed. David L. Sills, p. 425.

authorities in an embarrassing position. As a result of these lags, the effectiveness of monetary measures have considerably reduced in India.

In a developing economy, the scope of monetary policy is also limited due to existence of a large non-monetized sector. While it is difficult to estimate very precisely the extent of transactions carried out without the help of money, it has been estimated that approximately one-third of the total transactions in India is being done in non-monetized sector[1]. Therefore, a considerable part of the aggregate economic activity is outside the scope of monetary policy.

In addition to the non-monetized sector, there are also non-bank financial intermediaries in a significant amount in India. Professor Gurley and Shaw have argued that the rapid growth of non-bank financial intermediaries weakens the control and scope of monetary policy in the economy. It is acknowledged that all the financial intermediaries (banking and non-banking) can create lonable funds. Therefore, it is natural that due to similarities between non-bank financial intermediaries and commercial banks, the non-bank financial intermediaries become strong rivals of commercial banks and

1. R.J. Mody, New Dimensions Of Monetary Management (Delhi: The Macmillan Company of India Ltd., 1974), p. 40.

lies outside of the control of central bank[1]. Non-bank financial intermediaries in India also perform the important role of activiting idle hoards in addition to functioning as brokers of lonable funds. However, the main threat due to the growth of non-bank financial intermediaries is supposed to be in respect of credit expansion. In times of stringent monetary policy, the non-bank financial intermediaries may be able to attract more deposits from banks by raising their rates of interest. The banks may not be in a position to pay these higher rates of interest due to statutory restrictions, and the monetary authorities would not be able to restrict the credit issued by non-bank financial intermediaries[2]. This controlled credit expansion by these non-bank financial intermediaries is assumed to have threatened the effectiveness of monetary policy in India.

An outstanding feature of underdeveloped money market, like that of India, is its seasonality. In a developing economy there are various complications of seasonal variations of credit expansion. The commercial banks expand credit during the busy-season (November to April) and contract

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1. John G. Gurley and Edward S.Shaw, Money In a Theory of Finance (Delhi: Motilal Banarasidass, 1968), p. 243.
2. M.S. Joshi, "Monetary Policy and the Non-Bank Financial Intermediaries" in Monetary Policy And Central Banking eds. V.R. Mutalik Desai and B.D. Ghonasgi, p. 131.

credit during the slack-season (May to October). Since, main economic activity being agriculture, it needs large sums of money in post-harvesting season for marketing, distribution and shortage of agricultural produce. And since agricultural produce is acceptable as collateral security for credit, there is an expansion of bank credit in the busy-season and a contraction in the off season[1].

As the process of economic development continues, the impact of seasons on economic activities are bound to reduce. Therefore, the non-seasonal advance which do not follow seasonal pattern, are bound to increase in both the seasons. There are also variations in agricultural production from year to year which requires readjustment of credit expansion. It is, therefore, necessary to adjust seasonal changes to long-term trend in the economy[2]. Otherwise, the effectiveness of monetary policy will tend to be limited.

Apart from these constraints, the effectiveness of monetary policy in India is also limited due to various types of controls, such as, capital issue control, Licensing control, Raw material control and the Import control, which

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1. B.D. Ghonasgi, "The Monetary Policy in a Developing Economy : An Assessment" in Monetary Policy and Central Banking in India, eds. V.R. Mutalik Desai and B.D. Ghonasgi, p. 163.

2. B.D. Ghonasgi, "Monetary Policy in a Developing Economy: An Assessment" in Monetary Policy And Central Banking in India, eds. V.R.Mutalik Desai and B.D.Ghonasgi, p.164.

are influenced by various government agencies. As a result, the scope for taking independent decision by the monetary authorities is restricted and the Reserve Bank finds it difficult to pursuit of an independent monetary policy[1].

The above discussion leads to conclude that amidst various constraints success or failure of monetary policy in India depends upon banking system, the degree of integration within the system, its organisation and the extent of coordination among various factors.

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1. Professor Muranjan in The Monetary Policy Of The Reserve Bank of India, Rapporteur S.N. Sen, Papers read at the Indian Economic Conference, Bombay, 1963 (Bombay:Popular Prakashan, 1964), p.233.

CHAPTER II

IMPORTANCE OF GROWTH WITH STABILITY

2.1. Urgency of Economic Growth

Expansion, development or growth is the law of nature. This is the reason that "today, as never before, the world has become development concious"[1]. Hence, the fundamental objective of accelerating growth is more or less similar both in the case of the developed countries as well as in countries going through development. The only difference, however, is, while the developed countries dissatisfied with their rate of economic growth, are trying only to promote their all-round achieved rate of growth; developing countries are making their efforts to sustain not only growth but also to build up the potential for future growth.

The importance of the objective of economic growth also arises because it helps in achieving the fulfilment of other important socio-economic objectives of the economic policy along with itself[2].

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1. S.L.N. Simha, Development With Stability : The Indian Experiment (Bombay : Vora & Co. Pub. Pvt. Ltd.,1963), p.1.

2. For details, see, John Mills, Growth And Welfare : A New Policy for Britain (London : Martin Robertson, 1972), pp. 54-83.

According to V.K.R.V. Rao, the objective of economic development gets priority than the objective of full employment, because in effort to achieve full employment, maximisation of the employment opportunities which is to be brought about by increasing effective demand to the limit beyond, will result in inflation; while on the other hand economic development increases the level of employment, which is to be brought about by increasing the volume of the complementary resources necessary to secure the productive employment to available labour[1].

Rapid growth and transformation of the economy is of course particularly important in the less developed countries; there is no other way of providing the incomes and jobs that are so desperately needed. The importance of rapid growth was emphasised to the solution of employment problems of developed country like United States also[2].

The attainment of the goal of economic growth also solves the problem of inequalities of income. For this goal of social justice, the proper emphasis has to be given on the distribution pattern, and "....the basic approach will have lay relatively greater emphasis on the redirection of

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1. V.K.R.V. Rao, "Full Employment and Economic Development", Indian Economic Review, Vol. I, August, 1952, p.52.

2. International Labour Office, Employment And Economic Growth, p. 66.

investment sector-wise and socio-economic group-wise to raise the level and growth of income of lower income groups".[1] But in bringing about such a change in the strategy and to reallocate the investment, income and wealth in various planned programmes so as to remove inequalities in different socio-economic groups, it is necessary to bring about rapid economic growth[2], because "...distributional objectives cannot be thought of independently of growth objectives"[3].

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1. T.K. Lakshman, "Economic Growth and the Problem of Inequalities of Income - A Comparative Study of the Developed and the Developing Countries with Particular Reference to India", in Indian Economic Development and Policy, essays in honour of Professor V.L.D'Souza, eds. P.R. Brahmanand, D.M. Nanjundappa and B.K. Narayan (New Delhi : Vikas Publishing House Pvt. Ltd.,1979), p.191.

2. It may be mentioned here that in spite of their accelerated rate of economic growth, the inequality conditions have been worsen in a number of developed and developing countries. But this is due to many other factors. In developed countries, the main factors responsible for the situation are - the differing laws of inheritance; practices of nepotism and class favourtism; discrimination on grounds of race, sex and age; restriction on educational opportunities and specialization of occupations; and the pattern of ownership of physical and human capital.

   In developing countries, this is due to structural problems, mainly related to the limited ability of the economies to absorb the growing labour force and to the recent disruption to world trade caused by increased oil and food prices.

3. T.K. Lakshman, "Economic Growth and..." in Indian Economic Development and Policy, eds. P.R. Brahmananda, D.M.Nanjundappa and B.K. Narayan, p. 191.

In this way, it is clear that the urgency of economic growth and development is so pressing in the developing countries, that it has become prime objective of economic policy in a growth setting.

2.2. External And Internal Stability

Having considered some of the advantages of economic growth and its priority over other objectives of economic policy, now it will be useful to see that what the 'stability' actually means in a growth setting.

Monetary stability has two aspects : the external and the internal. The concept of external stability is mainly concerned with the stability of external value of the currency; i.e., stability of exchange rates with a view of having a commandable grip over its exports and imports, balance of payments and foreign exchange position.

Internal stability, on the other hand, is mainly concerned with the stability of internal price level (though it covers the whole field of output, income and employment).

Nowadays, more emphasis is being given to the maintenance of internal stability. By and large problems of internal stability remain confined within the country, so within the easy reach. It is also worth mentioning that internal stability reacts on external stability. Therefore, internal stability of domestic currency may be said to be a measure

of its external stability. For these reasons, internal stability becomes the real indicator of economic growth and main steps of economic policy deal with it.

But the internal stability cannot be maintained automatically in process of development. The internal stability gets a jerk mainly due to one of the basic problems facing the developing countries; that is the shortage of investment capital which has to be suitably diverted into approved channels of economy in order to stimulate growth. This has been a major constraint on growth in India, where saving is inadequate in relation to investment needs. Therefore, it is not possible to finance the heavy investment expenditures wholly from voluntary domestic savings. Thus, in a developing economy, monetary expansion becomes a must to meet the increasing requirements in process of growth. But such expansion of money supply, which is done either by securing adequate external resources or through the means of taxation, deficit financing or credit creation, will lead to an upsurge in prices which, in turn raises the financial needs of the productive sectors. To meet the legitimate needs of these sectors, still more money is injected in the economy which, in turn produces more inflation, scattering the internal stability.

Now, it is a matter of controversy that whether growth will take place in such an inflationary background and

whether growth should be promoted through inflation ?

Two groups of thought, frequently referred to as the 'structuralist school' and the 'stability or monetarist school' have been emerged on this subject, having absolutely opposite views. The former group argues in favour of inflation for economic growth, while the latter group strongly supports growth only with stable prices. Now, it will be interesting and useful to go through the arguments of these rival groups.

2.3. Development Through Inflation

The main argument in favour of inflation is that it breaks the deadlock of low savings and steps up the rate of real savings through a redistribution of income. It has been argued that inflation shifts income flows from fixed income group to profit recipient group. This implies that when prices rise through inflation, money incomes of wage earners and other non-profit earner groups either remain unchanged or rise comparatively less than the prices; while on the other hand, money incomes of investing enterpreneurs rise more. Therefore, rising prices help in curtailing the consumption of non-saving wage earners and other fixed income consuming groups, as well as at the same time help to generate more savings in the economy because with rising prices there takes place a "transfer of real income from class with a high propensity to consume to class with a high

propensity to save"[1]. Thus, more savings are forced to take place for capital formation. Ragnar Nurkse advocates the policy of inflation for such forced saving because "so long as there is no increase in saving, there can be no increase in total net capital formation.....An increase in saving can come about in the present case only in the form of forced saving resulting from inflation"[2].

Inflation also induces enterpreneurs to expand the scale of their productive operations because it encourages borrowings. This argument is based on the ground that when any amount of money is borrowed from the bank, it bears a fixed money obligation for repayment after some time. When prices of goods tend to rise, the real value of the repayment obligations in terms of goods declines. Thus debtor gains

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1. N.C.A.E.R., Price Policy And Economic Growth (New Delhi: National Council of Applied Economic Research), Occasional Paper No.14, p.5.

2. Ragnar Nurkse, Problems of Capital Formation In Underdeveloped Countries (Delhi : Oxford University Press, second impression, 1974), p. 113.

   In relation to developing countries also, Nurkse supports inflation : 'We must admit that, over a wide range, inflation can be effective as an engine of forced saving, and is being effective in this sense in a number of underdeveloped countries today'. Ragnar Nurkse, Problems of Capital Formation in Underdeveloped Countries, p. 144.

at the cost of creditor and borrowing tendency encourages.

Apart from this, borrowing is also encouraged due to the lower real interest in comparison to prices. This argument is based on the assumption that in an inflationary background either money rate of interest does not rise or rises at less than the expected rate of interest than prices. The lower rate of interest provides a larger quantity of initial resources for investment. This also motivates entrepreneurs to expand their projects which, in turn provides them higher profits, higher savings and higher future investment resources. This process helps in a higher level of net capital formation. Therefore, growth is promoted.

Another argument in favour of inflation for development is that it helps to expand monetized sector of the economy. It is argued that money comes into greater use in development process. As a natural corollary to such process, a substantial amount of saving is done in the form of money. Consequently, there arises a definite trend towards greater demand for financial assets and the enlargement of money and capital markets. By opening the monetary tap in the initial stage, the concerned authorities may well satisfy the demand for additional money in the economy[1].

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1. Sid Mittra, A New Horizon In Central Banking, p. 144.

Thus, inflation helps in creating appropriate atmosphere for development.

Therefore, so long inflation redistributes current income towards higher forced saving and results in accelerated capital formation, it is a powerful stimulant to economic growth.

2.4. Development With Price Stability

The monetarists, on the other hand, lay much stress on the need to curb inflation because they firmly believe that inflation affects income distribution, consumption, saving, investment and capital formation adversely. Hence, economic development cannot be promoted in midst of the inflationary climate, as these factors are very important for economic development.

We now proceed with the more realistic arguments of monetarists against inflation and examine the process by which inflation effects various factors that are primarily responsible for development.

The validity of the entire argument of structuralists in favour of inflation depends upon the assumption of constant wages and salaries, and reduced consumption of the economy during the inflation. It is also stressed that it redistributes income in favour of entrepreneurs by providing them higher profits.

Though the assumptions and arguments of structuralists has been considered relevent to a few developed countries, some of the assumptions underlying this line of reasoning are not quite applicable to countries like India[1].

The very first assumption of structuralists of constant wages and prices is not correct, because it completely ignores the role and influence of trade unions. In practical, it is much difficult to release greater resources for investment through reduction in real wages of wage and salary earners in an inflationary situation as assumed in the structuralist's arguments, because in developing countries also workers are sufficiently organised and their unions are sufficiently powerful to press their employers for higher wages and allowances in response to increase in the price level. Therefore, inflation will no more remain an effective instrument of larger profits and larger forced savings. Hence, it will become impossible to fulfil even the basic need of larger investment for economic development.

Again, the argument of increased forced savings through inflation involves the assumption that consumers have money illusion. But there is possibility that once the people

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1. R.J. Mody, <u>New Dimensions Of Monetary Management</u> (Delhi: The Macmillan Company of India Limited, 1974), pp.24-5.

become acute conscious of inflation and once they anticipate it to continue, there may not be any money illusion. Rising prices and decreasing value of money may provide disincentives to servers. Therefore, real consumption may not fall but real saving may actually fall. An empirical study done by R.K. Diwan supports this view and concludes that rising prices have a negative effect on savings in India[1]. Thus, in other words, so far the increased savings of profit earners are offset by the reduced voluntary savings of fixed income groups, there is in fact very marginal or no net increase in saving and investment. Moreover, it is also possible that inflation, rather than reducing consumption of wage-earners, may reduce the voluntary monetary savings of the community as it know that the real value of money will keep on falling day by day with rising prices. Therefore, people's willingness to save in idle money form may fall and they keep (as they do in India) their assets in the form of socially unproductive ideal commodities, such as agricultural products, real estate, ornaments, gold, silver, jewellery, precious stones and even cow and bullocks whose value goes up with rising price level. Thus persistent inflation, which is generally characterized by increased

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1. R.K. Diwan, "The Effect of Prices on Savings", in Economic Development And Cultural Change, vol. 16, No.3, April 1968, p. 434.

speculative activities is not helpful in promoting growth. But speculation, induced by continued inflation, only feeds the forces of inflation.

The structuralists argue that inflation redistributes real income in favour of the profit earners on the cost of wage earners. Though some degree of forced saving may be possible through such redistribution but it leads to question of moral judgement and social justice that whether such a sacrifice in terms of real consumption is desirable in a country like India where mass of population is pitifully living below subsistence level. Thus the argument in favour of inflation is socially unjust because it imposes a greater burden on the mass of society and at the same time blesses to a few prosperous profit earners[1]. C.L.Vakil, therefore, has strongly condemned the inflationary process of development in Indian context:

"The extent to which inflation has widened the existing disparities between rich and the poor, has undone the good effects of planned development by depriving the poorer people

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1. In connection of the inflation, a survey of public opinion which was done on May 1, 1973 in Japan by 'Ashai Newspaper' is noteworthy. 51 per cent of Japanese people answered that living had become worse, 39 per cent of people answered unchanged and only 7 per cent better. Katsuhiko Matsuishi, "Monopoly Prices In Japan", in <u>Historic Journal of Economics</u>, vol.4, No.2, February, 1974, Tokyo, p. 54.

of the fruits of progress, has added to the miseries of that large number of people who are below the poverty line (40 per cent) and has made a mockery of all efforts at social justice or socialism or garibi hatao...."[1]

This social justice of uplift of the masses of the people, which is the symbol of development in a true sense, is of utmost importance. Rising disparities and miseries compell poor to cut down their all efforts to be social elements. Thus only production of goods does not mean anything. E.F. Schumacher in his work 'Small is Beautiful', has elaborated this idea that "Development does not start with goods; it starts with people and their education, organization, and discipline. Without these three, all resources remain latent, untapped, potential"[2]. Therefore, instead of solving the problem of inequalities of income and wealth (one of the major objectives of economic policy in India), it further complicates the problem.

Moreover, even when inflation transfers real resources towards profit earners, there is no guarantee of these

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1. C.N. Vakil, Poverty, Planning And Inflation (Bombay : Allied Publishers Pvt. Ltd., 1978), p. 264.

2. E.F. Schumacher, Small Is Beautiful, Indian rpt. (New Delhi : Radhakrishna, June 1978), p. 157.

resources being invested in worthwhile particular directions and productive process for capital formation. In fact, "inflation seems to make businessmen interested in buying and selling commodities rather than in manufacturing them"[1]. Again, it tends to divert productive resources towards luxury consumptions which cannot be regarded as productive and useful for promoting growth. In an inflationary situation, entrepreneurs usually undertake those investments which have a high degree of private benefits but a low degree of social benefits[2]. In these conditions the transfer of resources from wage earners to profit earners does not promote economic growth.

There are several other grounds on which the validity of inflation can be rejected.

This has been argued that in an inflationary situation, the monetary expansion and the lower rate of interest induce entrepreneurs towards more capital intensive techniques of production rather than labour intensive techniques because capital intensive techniques lead to a larger share of profits to the entrepreneurs and a small share to labourers. But the densely populated countries in process of development do not

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1. Irving S. Friedman, "Social And Political Aspects Of Persistent Inflation", in Development Digest, vol.XII, No.1, January 1975, p.8.
2. E.M. Bernstein and I.C. Patel, "Inflation In Relation to Economic Development", in IMF Staff Papers, vol.3, Nov., 1952, p. 383.

actually need tools and machines of the same degree of capital intensity as those used in the advanced economies where labour is relatively scare. Some of the equipments and hence also the techniques of production imported from more developed countries are likely to be highly capital-intensive and therefore, not well adapted to countries where capital is scare and labour abundant[1]. Therefore, in an over-populated country, such as India, inflation may be most disadvantegeous and dangerous in this case and may lead to even more and more unemployment. Hence, in a labour surplus economy, labour intensive techniques should be adopted which throw up enough investible surplus to ensure an increase in the growth rate of the economy in the future[2]. Again, it may also be possible that the rising prices might boost up entrepreneurial enthusiasm and throw up a rising demand for labour to raise the level of production. But in absence of technological progress, large volume of skilled labour and lack of resources, the consequence of higher money wages leading to higher costs and smaller profits may not be avoided[3]. Then, the enthusiasm of the

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1. Ragnar Nurkse, Problems of Capital Formation in Under-developed Countries, p.45.

2. Asit Banerji, Capital Intensity and Productivity in Indian Industry (Delhi:Macmillan, 1975), p.149.

3. P.D. Hajela, Problems of Monetary Policy in Underdeveloped Countries, p. 100.

entrepreneurs would end up in a rise of costs of production and would produce undesirable results because rise in prices would not be arrested in the absence of any corresponding rise in the production.

One more argument against inflation is that it encourages flight of capital abroad and attract foreign capital. It has been argued that in an inflationary background use of foreign capital is increasingly favoured over everhigher priced domestic labour and materials. At the same time inflation encourages domestic savers to safeguard their wealth by sending it abroad rather than trying to use it at home[1]. Such activities also produce negative effect on domestic economic growth.

Inflation also has a harmful effect on the balance of payments position. A developing country usually depends on trade for its economic growth. The effect of the rise in prices on the balance of payments depend upon the relative prices of commodities in the world market. If domestic prices are higher than world prices, people will hold more foreign goods because it has more attractive values than domestic goods. On the other hand, exports tend to decline from the demand side as well as supply side. Exports will

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1. Charles P. Kindleberger and Bruce Herrik, Economic Development (Tokyo:McGraw-Hill Kogakusha Ltd.,1977), p.224.

be declined through cost increase, thus demand would be hampered. On the other side, sale of goods on the domestic market will be more profitable, thus supply would be hampered. In both ways, inflation reduces exports and a wider negative trade gap is created between imports and exports, retarding balance of payments position and imposing more acute foreign exchange burden. Now, an equilibrium in balance of payments cannot be achieved either by imposing imports restriction or export promotion. By imposing imports restriction, the necessary development goods' imports would also be retarded which would make the growth process even more complex. And to export more, the supply of goods in the domestic market (which is already inadequate) would have to be further curtailed. It would further enhance the domestic inflation and the spiral would go on, making the problem of economic growth more and more complicated.

2.5. Emperical Findings

Now what conclusion can be drawn from the above arguments of structuralists and the monetarists ? What can be said quite definitely, however, is very difficult as there have been many examples in the past in favour of both the rival groups. There are large number of cases of substantial economic growth associated both with inflation as well as without it in developed and developing countries.

Hamilton[1] has claimed that inflation has been a powerful stimulant to growth in a wide number of historical contexts through the favourable effects of excess demand on profits, saving and investment; for example, in England and France in the sixteenth and seventeenth centuries and in England in the latter half of the eighteenth century.

But such examples relating more distant past and developed countries may not be wholly relevant in reference of domestic countries. Moreover, growth in these countries with the pressure of inflation might be a matter of chance and would have taken place due to some other factors rather than inflation. If we regard it exclusively due to inflation, inflation should have produced similar favourable results in every country and in every period.

But recent statistical analysis of various countries show that inflation have not produced similar results. In most of these countries highest degree of inflation was associated with very negligible or even negative rates of growth. In fact, inflation has ceased to promote development and has become incompatible with it; even those countries that managed to have inflation and development are now facing acceleration

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1. E.Hamilton, "Prices As a Factor In Business Growth : Prices And Progress", Journal of Economic History, Autumn 1952, p.37.

of inflation and a deceleration of development[1].

The former Governor of the Reserve Bank of India, L.K. Jha have also said in his study of developing countries that there is a little evidence to support the view that inflation stimulates growth but there is considerable evidence that it undermines it[2]. He has further remarked that inflation has created acute problems for growth "in country after country.... no reason to believe that growth and inflation must go together ....growth is the greatest enemy of inflation, and inflation is greatest enemy of growth"[3].

On the basis of good historical evidence Milton Friedman concludes that though no definite correlation exists between inflation and economic development but a stable and steady monetary framework rather than inflation is desirable for economic development and progress[4].

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1. Roberto de Oliveira Campos, "Two Views On Inflation In Latin America", in Latin American Issues:Essays And Comments, ed. Albert O.Hirschman (New York : Twentieth Century Fund, 1961), p.69.

2. L.K. Jha, "Price Policy In a Developing Economy", Reserve Bank of India Bulletin, April, 1968, p. 479.

3. L.K. Jha, "Growth Without Inflation", Reserve Bank of India Bulletin, December 1969, p.1904.

4. Milton Friedman, Inflation : Causes And Consequences (Bombay : Asia Publishing House, 1963), pp. 1-51.

According to Thirlwall and Barton[1], in the case of strongly inflating developing countries there is a definite negative association between the growth rate and the inflation.

Wallich[2] has also found the similar results of negative relation between inflation and growth in an empirical study of forty-three countries over the period 1956-65.

Irving S. Friedman[3] also argues that the main cause behind the comparatively slow or negligible growth rate of thirty-seven developing countries in the 1960s was the high rate of inflation in these countries which was higher in the 1960s than in the 1950s, and it has increased further in 1970s. He has categorised these countries in different groups

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1. There have been several empirical studies designed to test the controversial views of positive or negative relation between inflation and economic growth. Perhaps the most thorough and conclusive of these studies has been done by Thirtwall and Barton, who after taking data of average annual inflation rate for the period 1956-67 and the average annual rate of increase of real G.N.P. for the same period each of fifty-one countries has come to their conclusion.
   A.P. Thirlwall and C.A. Barton, "Inflation And Growth: The International Evidence", in Banca Nazional del Lavoro Quarterly Review, September 1971, p. 265.

2. H.C. Wallich, "Money And Growth : A Country Cross-Section Analysis", in Journal of Money, Credit and Banking, May 1969.

3. Irving S. Friedman, "Social And Political Aspects Of Persistent Inflation", in Development Digest, vol.XIII, No.1, January 1975, p.5.

according to their varying inflationary situations. Countries with inflation of the general magnitude (0-5% per annum), snapped the world: Mexico, Guatemala, and Costa Rica; Tunisia and the United Arab Republic; Ceylon, Pakistan, Thailand, and Malaysia; and Nigeria in Western Africa. Higher rates of inflation (5-15% per annum) were also found throughout the world: Isreal, Korea, Trinidad and Tobago, Kenya, and India. The most rapid inflations (15-50% per annum) occured mostly in South America: Brazil, Chile, Colombia, Argentina, and Uruguay. But the worst case of the 1960s was in Indonesia where inflation reached over 1000 per cent per year.

Cleveland and Bruce Brittain, after studying the statistical relation between inflation and economic growth in ten leading industrial countries (U.S.A., Canada, Japan, U.K., Germany, France, Italy, Netherlands, Belgium and Switzerland) for the period 1960-75 have given following table which clearly shows that inflation is negatively associated with growth:

Table : 1

Annual or Annualized Percentage Change of Period Averages of Inflation and Real G.N.P. for selected countries

Country	Year	Inflation	Real G.N.P.
U.S.A.	1974	11.0	-1.8
	1975	9.2	-2.0
Canada	1974	10.9	2.8
	1975	10.7	0.2

contd...

Table:1 contd...

Country	Year	Inflation	Real G.N.P.
Japan	1974	24.4	-1.1
	1975	11.9	2.2
U.K.	1974	16.0	0.5
	1975	24.3	-1.6
Germany	1974	7.0	0.4
	1975	5.9	-3.4
France	1974	13.5	3.2
	1975	11.8	-3.5
Italy	1974	19.2	4.2
	1975	17.0	-3.8
Netherlands	1974	9.6	3.8
	1975	10.2	-1.8
Belgium	1974	12.7	4.2
	1975	12.8	-2.5
Switzerland	1974	9.8	2.1
	1975	6.7	-7.0
10 countries combined	1974	13.2	-0.1
	1975	10.8	-1.8

Source: Harold Van B. Cleveland and W.H. Bruce Brittain, *The Great Inflation*, pp. 54 and 58.

The above comparative studies show that there is not any positive relation between inflation and growth. In fact,

in various developed as well as developing countries where chronic inflation took place[1], and corresponding growth was not found with it.

In Indian context also, there is no evidence that rise in price level is associated with acceleration in the pace of economic growth. In the race among economic growth and inflation, the latter has gone far ahead in India. The following table which indicates the annual rate of change in prices and annual growth rates during Plan period in India, shows that there is no correlation between inflation and economic growth.

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1. Inflation continued to sap world economic strength in the year 1980. A survey by International Labour Organisation for the year 1980 showed that most of the developed and developing countries had high inflation rates during that period. Isreal led the global inflation league with consumer prices jumping 131.5 per cent. Most of the developed countries had price increases of between 10 and 20 per cent — Australia (10.3 per cent), Canada (10.7 per cent), United States (12.6 per cent), Norway (12.9 per cent), France (13.6 per cent), Sweden (15 per cent), United Kingdom (16.9 per cent) and New Zealand (16.4 per cent). Inflation rates of more than 20 per cent were reported by Italy (21.3 per cent), Greece (24.4 per cent), Yugoslavia (31.1 per cent), and Iceland (57.6 per cent). Developing countries had also high inflation rates. Argentina reported inflation of 88 per cent, Bolivia (50.4 per cent), Chile (30.4 per cent), Colombia (27.2 per cent) and Venenzuela (22.2 per cent). Among African countries, Mauritius had the highest inflation rate of 48 per cent, and Sri Lanka topped the Asian table with a rate of 43.3 per cent. The Hindustan Times February 19, 1981, p.21.

Table : 2

Annual Rate of Change in Prices and Annual Growth Rates in India

Period	Wholesale Price Index (Base 1952-53 = 100)	Annual Growth Rates
First Plan (1950-51 to 1955-56)	3.9	3.6
Second Plan (1955-56 to 1960-61)	6.2	4.0
Third Plan (1960-61 to 1965-66)	5.7	2.5
Three Annual Plans (1966-67 to 1968-69)	7.8	4.1
Fourth Plan (1969-70 to 1974-75)	8.9	3.4
Fifth Plan (1974-75 to 1979-80)	10.3	3.7

Source: Economic Survey, 1980-81

The table clearly shows that while the prices have gradually reached at the rate of 10.3 per cent annual change during Fifth Plan Period from 3.9 per cent in First Plan, the annual growth rate has remained almost at the same level during Fifth Plan as it was during First Plan.

2.6. Meaning of Price Stability in India

In the context of a developing economy with a 'Welfare State' as a goal, the need for maintaining a stable price level is generally emphasised. When in the early stages of economic planning in India emphasis came to be placed on the twin objectives of development and stability, attention was mainly concerned on the maintenance of a stable level of prices and on the avoidance of serious inflationary pressures. It was recognised that while increased public expenditure on schemes of economic development is helpful means of promoting growth, the keeping under control of an uptrend in the price structure is a pre-requisite for ensuring better distribution and enjoyment of the fruits of economic development by the society.

As we have already seen in the previous pages that the experience in many developing countries using inflation-induced growth has not been very favourable. The rate of inflation at times for exceeded the rate of economic growth. Consequently, inflationary growth policy adopted in some developing countries has been gradually reversed towards monetary and price stability. P.Z. Baldik says that it is only the stability of prices which leads to overall development. He says, "once price stability is ensured, the process of transformation of society from an agricultural economy to an industrial economy is smooth, without much of

an economic upheaval or distortion. Therefore, our basic approach should be to have reasonable price stability....."[1] In developed countries also the need of stable prices was well emphasised. "In Great Britain there was a considerable body of opinion, led by economists but backed by industrialists, which demanded a policy of price stabilization. In the United States the same demand inspired Congress, and more than one Bill was introduced to put upon the Federal Reserve Bank the statutory duty of maintaining stable prices"[2].

But, in India, the last three decades of the planning have, in fact, shows that the price stability that was regarded as desirable was not achieved. The persistent rise in prices has been a matter of serious concern for the country. It has not only adversely effected the planned programme for development, but also has threatened to all the achievements and cherished goals of the country. In the race among production, population and prices, the last has gone ahead in India. The country has been facing mounting inflationary pressures as a result of complete lack of any price policy. The crucial role of an effective price policy for successful implementation of planning in a mixed economy has also

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1. P.Z. Baldik, "Growth With Stability : Need for Raising Investment", Capital, Annual Number 1978-79, p. 53.

2. Geoffrey Crowther, An Outline of Money, p. 316.

been well recognised in the development plans of the developing countries. Among the main objectives of a price policy, the need for price stabilisation has been most commonly advocated[1].

Thus, it is generally agreed[2] that so far as Indian economic development is concerned, inflation has created difficulties in achieving a high rate of economic development and since 1951 the Indian economy has been witnessing only inflation without any evidence of faster economic growth. Therefore, the Plan for economic development must be such as to exercise the minimum possible inflationary pressure. For this reason, the price stability was accepted as a necessary condition for successful implementation of a development programme. Development can be better achieved during a period of price stability rather than during a period of inflation. Price stability is also a necessary condition to maintain a long run growth. It has been argued that "....economic growth in underdeveloped countries has to be achieved with 'substantial' price stability, if forces

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1. Suraj Bhan Agrawal, Price Trends In India : Since 1951 (Delhi : Sultan Chand & Sons 1972), pp. 188-89.

2. For details, see, M.Shabbir Khan (Rapporteur), Price Level And Economic Development (Bombay : Popular Prakashan, 1970), Papers read at The Indian Economic Conference, Hyderabad 1968, pp.xi + 74.

which impede growth in the long run are to be avoided"[1]. Otherwise, development without such stability would carry in it the seeds of its own destruction.

The first systematic exposition of the need for price stability as a necessary condition for economic development in the Indian context was given by a technical mission of the International Monetary Fund which came to India in early 1953, headed by the then Director of Research Dr. E.M. Bernstein[2]. The mission produced a report entitled 'Economic Development with Stability'[3]. The analysis attempted in this report meant by stability only the stability of prices. The Bernstein report also clarified that the objective of price stability would mean neither complete price rigidity, nor an absolutely constant level of the general price index. The basic fact was that while the mission was strongly against anything that would generate strong inflationary pressures, as they emphasised that production distortions was caused by inflation. But the mission was

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1. D.K. Shukla, "A Theoretical Model and its Implications For Economic Growth in India", in <u>Theory Of Economic Growth</u>, Amlan Datta (Rapporteur), Papers read at The Indian Economic Conference, Madras, 1967, p.45.

2. The other members of the mission were Dr. I.G.Patel, Dr. Richard Goode and Dr. Morris Friedberg.

3. For details, see, E.M. Bernstein and I.G. Patel, "Economic Development With Stability", <u>IMF Staff Papers</u>, Vol.VIII, No.3, February 1954, pp. 313-86.

against price stabilisation through direct economic controls. The recommended course was to allow the market forces to operate within the bounds of an overall anti-inflationary policy as the mission believed that the controls that sought to suppress the market forces would produce distortions as undesirable as those caused by the free play of inflation[1]. This is an area in which the Government of India has made some departure from the mission's thinking, though it must be added that price controls have been administered with some flexibility, otherwise the approach of the Bernstein mission appears to have been broadly the same as that of the Indian authorities, and, in fact, in latest years too the Government and the Reserve Bank of India have been pursuing policies that are broadly in consonance with the mission's views[2].

Now, it will be useful to see that what the stable prices actually mean. C.N. Vakil also feels that "while talking of reasonable price stability as the pre-requisite of development, the statement does not make it clear as to the level at which the prices will be stabilised"[3]. The

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1. Bhabatosh Datta, "Achieving Growth With Stability", Capital, Annual No. 1978-79, p.27.

2. S.L.N. Simha, Development With Stability: The Indian Experiment, pp. 16-70.

3. C.N. Vakil, Janta Economic Policy : Towards Gandhian Socialism (Delhi: The Macmillan Company of India Ltd. 1979), p.14.

term 'price stability' is often confused with the constant price level over a period of time. But actually the stability of prices does not mean keeping the prices absolutely constant or fixed at a pre-determined level. A rise in production and national income cannot assume a constant horizontal price level. Because with the increase in the economy's growth (output, employment, income and expenditure), price are also bound to rise. Thus, it is quite impossible and not wise to maintain absolute rigidity in the price structure in a complex economy such as ours. Stability in such context of a developing economy means that prices are not allowed to rise or fall in any period beyond certain minimum and maximum limits with reference to prices in the previous period, i.e., the purchasing power of the currency within the country must remain reasonably stable over a period of time. It must, however, be mentioned here that in a developing country, with inflationary conditions, the chances of prices falling below the minimum limit are rare[1]. The continuous inflationary experience in our country has proved it. Therefore, in Indian context, the stability of price level actually means preventing the upward fluctuations of prices and checking it from going above the desired maximum level.

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1. P.C. Jain, "Price Stability", in The Third Five Year Plan and India's Economic Growth, ed. B.C. Tandon (Allahabad: Chaitanya Publishing House, 1962), p. 124.

There are different opinions among economists regarding this maximum limit. But it is widely agreed that a mild and almost continuous degree of price rise is necessary "in order to pump the necessary amount of forced saving out of the community"[1] for economic development.

Irving S. Friedman says that "the disruptive effects of inflationary expectations might be regarded as minimal if the public could expect more or less regular price rise of 1 per cent or more"[2].

But in the Indian context this 'acceptable' rate is some higher.

According to N.C.A.E.R., "A price level rising at about 2 per cent a year, not more and perhaps a bit less, constitutes a desirable objective for the Indian economy at the present time"[3].

V. Krishna Murty believes that mild dose of inflation provides auspicious climate both for the maintenance of full employment and satisfactory rates of growth; and a little

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1. Alvin H. Hansen, Economic Issues Of the 1960s, p. 174.
2. Irving S. Friedman, "Social and Political Aspects of Persistent Inflation", in Development Digest, p. 6.
3. N.C.A.E.R., Growth Without Inflation (New Delhi : National Council of Applied Economic Research, 1965), p.25.

inflation entailing a price rise to the extent of 2 or 3 per cent would not force or induce people to reduce their cash balances to any considerable extent to initiate the cumulative process of inflation. For small changes of prices, people in general are rather insensitive. It is rather this insensitivity which is responsible for the stability of economy[1].

H.V.R. Iengar also strongly supports the mild rise in price level, "I repeatedly stated that I accepted the position that a certain degree of price increase was inevitable, but I suggest that such increase should not exceed some two to three per cent per year"[2].

Thus, it seems reasonable to suggest that prices would be 'stable' if they do not rise or fall beyond two to three per cent per annum for any category of goods. Only such mild increase in the price level would achieve the twin objectives of growth with stability.

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1. V. Krishna Murty, Monetary Equilibrium And Economic Development (Bombay : Popular Prakashan, 1971), p.120

2. H.V.R. Iengar, Role Of Central Banking Authority And Commercial Banks in a Planned Economy, A.D. Shroff memorial Lecture delivered on 6th December 1967 (Bombay: The A.D. Shroff Memorial Trust, 1969), p.7.

In broader perspective, it may be said that the economic growth and monetary stability are so closely linked up, that they cannot and should not be treated as two separate objectives. In fact, they are inter-related and there is no conflict between the two[1].

Therefore, maintaining of price stability has now become the utmost important objective of monetary as well as overall economic policy in India.

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1. H.N. Roy, The Role Of Monetary Policy In Economic Development (Calcutta: The World Press Private Limited, 1962), p.27.

CHAPTER III

THE INDIAN MONEY MARKET

The effective performance of monetary policy in a country is largely conditioned by the pattern and structure of financial institutions that exist in the money market of the country. Thus, in order to assess the role and working of monetary policy in India, it is necessary to examine the institutional framework and environment of the economy in which the policy operates.

The operations of the monetary policy depend upon the structure and nature of money market as its base, because it is a natural point of contact between the central bank (which is the central monetary authority of the country), and other financial sectors of the economy. Therefore, the effective organisation and response of the financial institutions in general and banks in particular which depend upon the nature of organisation of the money market and degree of cooperation between its various components, are mainly responsible for the implementation of monetary policy in an economy[1], because, "Monetary management is largely

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1. V.R. Mutalik Desai, "The Structure of the Money Market in India", in Monetary Policy And Central Banking in India, eds. V.R. Mutalik Desai and B.D. Ghonasgi (Bombay: Popular Prakashan, 1969), p. 1.

governed by institutional factors like the use of credit, credit consciousness of the people and their preferences, the general banking structure and development and banking habits of the people as a whole"[1].

The outstanding feature of the Indian money market is its dichotomy; it comprises broadly two distinct sectors (i) the organised and (ii) the unorganised; with a large scale divergence in the structure of interest rates in these two sectors.

3.1. The Organised and Unorganised Sectors

The organised sector which is comparatively well developed in terms of specialization of function, consists of the Reserve Bank of India, the State Bank of India, commercial banks, foreign banks, the Indian joint-stock banks, quasi-government bodies and the large-sized joint-stock companies. There are also loan brokers, general finance brokers, stock-brokers and other financial intermediaries[2],

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1. G.P. Gupta, The Reserve Bank of India And Monetary Management, Second edn. (1959, Bombay : Asia Publishing House, 1962), p.18.

2. S.L.N. Simha, "Central Banking In India", in Central Banking In South And East Asia, ed. S. Gethyn Davies (Hong Kong : Hong Kong University Press, 1960), p.31.

viz., the Life Insurance Corporation, Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India, Unit Trust of India, State Finance Corporation of India, Industrial Development Bank, Agricultural Refinance Corporation, Land Mortgage Banks, Insurance Companies and so on[1].

The unorganised sector of the money market is not homogeneous. This sector consists of a group of various indigenous agencies, each with different business practice and a different structure of interest rates. It is largely made up of indigenous bankers, money-lenders, traders, commission agents etc., some of whom combine money-lending with trade and other activities[2]. In this market, there is no clear demarcation between short-term and long-term finance, nor even between the purposes of finance inasmuch as there is usually nothing on a 'Hundi' (which is the indigenous bill of exchange) to indicate whether it has been issued for financing trade or simply for providing financial accommodation. In other words, it may be a trade bill or a financial paper. In view of the paucity of trade

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1. V.R. Mutalik Desai, "The Structure of Money Market in India" in Monetary Policy and Central Banking in India eds. V.R.Mutalik Desai and B.D. Ghonasgi, p.3.

2. V.R. Mutalik Desai, 'The Structure of the Money Market in India' in Monetary Policy and Central Banking in India, eds. V.R. Mutalik Desai and B.D. Ghonasgi, p.3.

bills, there is no well developed discount market in India, though banks, especially the foreign banks, discount bills of approved parties after fulfilling certain conditions. Trade bills are usually carried until maturity[1].

The cooperative credit institutions have somewhat intermediate position between the organised and the un-organised sectors of the market. These institutions were setup with a view to supplanting the indigenous source of rural credit, particularly the money-lenders. Though the objective is not fully achieved, considerable efforts and progress have been made to integrate cooperative credit system into the organised sector. The Reserve Bank of India has stepped up substantially the scale of assistance to the cooperative sector, and the cooperative credit institutions are being brought into close contact with commercial banks, vis-a-vis, into closer links with organised sector of the money market[2].

The two sectors of the money market in India can be further divided into various categories according to the area, nature and other practices of their activities. The present structure of the Indian money market in India is summarized in Chart (1).

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1. Reserve Bank of India, Functions and Working, p.36.
2. Reserve Bank of India, Functions and Working, pp.37-8.

Chart:1

Indian Money Market
Organised Sector
Unorganised sector
Reserve Bank of India
Commercial Banks
Cooperative Banks
Indian Joint Stock Banks
Foreign Banks
State Cooperative Banks
District Cooperative Banks
Primary Credit Societies
Scheduled Banks
Non-Scheduled Banks
Nationalised Banks
Non-Nationalised Banks
Indigenous Bankers
Indigenous Money Lenders
Professional (Pure) Bankers
Non-professiona Bankers
Professiona Money lende
Multanies
Shroffs
Chettiars & Brahmins
Other
Commission Agents
Marwaries
Chettiar Traders
Others

3.3. The Bill Market

Another important aspect of the Indian money market is that there is no genuine market for bills in India, either commercial or treasury; nor is there any acceptance business. It may be observed that prior to 1952, there was no bill market in India. Reserve Bank introduced the Bill Market Scheme under the provision of Section 17(4)(c) of the Reserve Bank of India Act, 1934, w.e.f. January 16, 1952. But it has achieved limited success in this field. The scheme has achieved success only in the organised sector of the money market. The Reserve Bank failed to extend the scheme to un-organised sector, which still controls about 50 per cent of the financing in the market[1].

The scheme also makes no provision for the indigenous banker's 'hundi', which is most important form of credit instrument in un-organised sector of the economy, and thus fails to integrate the two sectors of the money market[2].

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1. C.R. Basu, Central Banking in a Planned Economy: The Indian Experiment, second edn., (1977, New Delhi : Tata McGraw-Hill Publishing Co. Ltd., 1978), p. 32.

2. Hirendra Nath Roy, The Role Of Monetary Policy In Economic Development (Calcutta : The World Press Pvt. Ltd., 1962), p.90.

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2. Hirendra Nath Roy, The Role Of Monetary Policy In Economic Development (Calcutta : The World Press Pvt. Ltd.,1962), p.90.

Therefore, non-existence of an effective and developed bill market[1] is a major limitation on the effectiveness of monetary policy in India.

In fact, the Indian money market is loose, haphazard and disorganised, with supreme rule of indigenous bankers and money-lenders to a significant extent even at present. They have remained outside the network and control of central banking. The agricultural sector, which is the backbone of the Indian economy, is left in the hands of those indigenous bankers and money-lenders[2], who by their unique position in

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1. S.L.N. Simha has given various reasons for the absence of a bill market in India, namely: the lack of uniformity in drawing bills in different parts of the country; the practice of extending credit not subject to any specified time-limit but collected by travelling salesmen; the large use of cash credit or overdraft as the main form of borrowing from banks; the preference for cash transactions in certain lines of activity; the paucity of warehousing facilities for agricultural produce; and the high stamp-duty on usance bills.
   S.L.N. Simha, "Central Banking In India", in Central Banking in South and East Asia, ed. S. Gethyn Davies, p.32.

2. To get clear picture of the main features of rural credit in India, a survey was conducted by the Reserve Bank of India, under the Chairmanship of Shri Gorewala.
   The findings of the Survey reveals that out of the total amount borrowed by the cultivators, 3.3 per cent was from Government, 3.1 per cent from cooperatives and 0.9 per cent from commercial banks. Landlords and traders were also not important credit agencies, borrowing from them forming only 1.5 per cent and 5.5 per cent respectively of the total borrowings of cultivators. Relatives supplied

fn.contd....

the rural economy advance loans on their own terms and conditions for productive purposes and social needs too. The relationship between the money-lenders and borrowers is so personal that ordinary loans are made sometimes without any security or even a promissory note, but sometimes against the security of standing crops, gold, jewellery or land.

There is no rule regarding interest rates charged by these financial agencies. There is not a single rate of interest in the economy. A wide range of interest rates prevail in the entire market at the same time. Interest rates charged by these money-lenders are generally much higher[1] than those of banks, and usually vary from 18.75 per cent to 37.5 per cent per annum.

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fn.2 of previous page continued

14.2 per cent credit obtained by the cultivators. By far, the most important credit agencies were the agriculturists and the professional money-lenders who advanced 24.9 per cent and 44.8 per cent respectively of the total amount borrowed by the cultivators.

P.D. Hajela, Problems of Monetary Policy in Underdeveloped Countries : With Special Reference to India, p. 224, that is further taken from All India Rural Credit Survey, 1957, Vol. I, part 2, p.1.

1. In exceptional cases, interest rates may be 100 per cent per annum.

G.L. Karkal, Unorganised Money Markets in India (Bombay: Lalvani Publishing House, 1962), p.87, that is further taken from L.C. Jain, Indigenous Banking in India, p.94.

The money market structure, though loose, is not entirely un-coordinated. The indigenous bankers get rediscount facilities from the commercial banks which, in turn, have access to the Reserve Bank of India. Recourse on the part of the indigenous bankers to the resources of the organised money market takes place usually during the busy-season. Recently, however, such resources by the indigenous bankers to the organised sector have been declined considerably. The Reserve Bank of India is trying to curb the activities of money-lenders by encouraging banking expansion in rural areas[1].

Further, "....the unorganised sector of the money market has been strengthened with the addition of 'unaccounted money', variously known as black money or unaccounted gains or untaxed assets....The impact of unaccounted money on the money market is very significant. With the growth of unaccounted money in the country, a number of mushroom indigenous bankers have grown up... The unaccounted money as a part of indigenous money market is being invested in property, small-scale industry, smuggling, hoarding and trade. This has further limited the effective implementation of the monetary policy...."[2].

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1. Reserve Bank of India, Functions and Working, p.37.
2. V.R. Mutalik Desai, The Structure of the Money Markets in India, pp. 16-7.

Moreover, such dangerous parallel economy of black money is increasing rapidly[1]. The President of India, Mr. Neelam Sanjiva Reddy, while recently describing the black money as 'blood cancer', has also called for strict and stern measures to check its 'cancerous growth' in the country[2].

The bulk of such black mondy, which helps illegal hoarding, speculative trading and generation of windfall gains, has necessarily an adverse effect on the proper working of monetary policy in India.

3.2. The Capital Market

Like the money market, the Indian capital market is also characterised by both organised and unorganised sectors. Though the organised sector is fairly well developed, mobilizing savings of the community and channelising capital to meet investment demand of various fields, but still the Indian

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1. J.D. Sethi confidently feels that at the root of India's multiple economic crisis, lies the black money. According to him, currently about ten per cent of the G.N.P. is in the black sector and ever since Professor Nicolas Kaldor had submitted his estimate of black money in the mid-fifties, the relative share of black money to the open economy has been increasing.
   J.D. Sethi, India in Crisis (Delhi:Vikas Publishing House Pvt. Ltd., 1975), p.77.

2. Northern India Patrika, 25 July 1980, p.1.

capital market is far behind the level of a well developed capital market[1]. Thus, the Indian capital market is hardly sensitive enough to transmitting the impulses of monetary regulations in the economy.

3.3. The Commercial Banking System

The most significant segment of the organised money market is the commercial banking system. The following table gives a broad picture of the growth of commercial banking in India.

Table:3

Number of Commercial Banks in India

Period	Population (in lakhs)	Number of Bank Offices	Number of offices per lakh of population
End December 1951	3,611	4,178	1.16
" " 1956	3,975	4,193	1.05
" " 1960	4,327	4,939	1.14
" " 1961	4,424	5,012	1.13
" " 1965	4,868	6,131	1.27

table contd..

1. According to B.K. Madan, the normal conception of a capital market consisting of issue houses, investment companies, professional promoters, or syndicates does not hold to any great extent in India. There are not many issue houses nor are there investment companies in any large number. The few institutions of this nature that do exist are of rather recent origin. Thus, the charecteristics of a well-developed capital market are virtually absent from the Indian Capital Market. Bal Krishna Madan in Banking System, ed. Haggot Benjamin Beckhart, rpt.(Bombay: The Times of India Press, 1970), p.43.

Table 3 contd..

2nd June 1970	5,373	10,131	1.89
" " 1971	5,512	12,013	2.18
" " 1978	6,384	28,016	4.39
" " 1979	6,510	30,202	4.63
" " 1980	6,636	32,149	4.84

Source: For Population, Economic Survey, 1980-81; and for bank offices Statistical Tables Relating to Banks in India (various issues) and Eastern Economist, Annual No. 1981, 23 Jan., 1981.

It is obvious from Table 3 that the number of bank offices increased from 4,178 in 1951 to 32,149 in 1980. The commercial banks occupy a predominant position in the money market for effectiveness of monetary policy. In fact, the banking system is the channel through which the impulses of monetary regulation are transmitted to the rest of the economy. This is possible that the banks can operate in manner to strengthen the monetary control or weaken their general effect. An adequate growth of banking industry is necessary to strengthen the effectiveness of monetary policy. The nationalisation of 14 major commercial banks in June 1969 and of 6 other major commercial banks on April 15, 1980 is a healthy step to boost the banking industry and to have a more powerful control over it. 'Branch expansion' programmes have also helped in spreading the net work of bank offices in the country. The number of bank offices in

relation to population size is an indicator of development of banks. The average number of offices per lakh of population which was 3,611 lakhs in 1951 has considerably increased to 4.84 in 1980. But, in spite of the phenominal growth of banks in India, the process of their growth is still inadequate to the needs of economy. The average population served by a bank office in India is still very high than those in many developed countries.

It may be concluded by the above discussion that though the structure of Indian money market is gradually developing with time, but a considerable part of the economy is still outside the purview of monetary policy in India.

It will be useful, in this context, to discuss the role of Reserve Bank of India which assumes special significance and responsibility in India as the chief controller of the commercial banks in the country and the central bank of India. This has been discussed in next chapter.

CHAPTER IV

MONETARY POLICY AND THE RESERVE BANK OF INDIA

4.1. Establishment Of The Reserve Bank of India

The earliest reference that has been traced regarding an attempt to setup in India a bank which had some characteristics of a central banking institution of today dates as far back as January 1773, when Warren Hastings (the then Governor of Bengal) placed before the Board of Revenue his 'Plan' for a 'General Bank in Bengal and Bihar'. The plan for the proposed bank was approved by the Board with some changes, and the bank was setup in April 1773, but it proved to be only a short-lived experiment.

There were several further attempts in the direction of establishment of a central bank. Later on Mr. Robert Rickards, a Member of the Bombay Government had also submitted a scheme for 'General Bank'. In 1836, another proposal for a 'Great Banking Establishment for British India' was submitted to the Court of Directors of the East India Company by a body of merchants in England having trade relations with India.

There were several other suggestions later, including an amalgamation of the three existing Presidency Banks of

Bengal, Bombay and Madras. Besides amalgamation, other proposals cropped up from time to time. In 1870, Mr. Ellis, Member of the Viceroy's Executive Council, suggested the setting up of one State Bank for India under complete Government control, with branches at the Presidency towns, generally on the model of the Bank of France. In 1884, a suggestion was made for the setting up of a 'central bank of issue' on the model of the Netherlands Bank.

The question of the amalgamation of the Presidency Banks was not taken up till 1898, when several witnesses before the Indian Currency Committee (Flower Committee) drew attention to the inadequate banking facilities in India and a few favoured the amalgamation of the Presidency Banks into a 'State Bank'. One witness, Mr. A.de Rothschild, outlined a scheme for the creation of a bank in India with similar privileges to those of the Bank of England. One of the members of the Flower Committee, Mr. Everard Hambro, urged the establishment of a strong bank in India.

The proposal of absorption of the three Presidency Banks into a central bank had not assumed a definite shape even when the Royal Commission of Indian Finance and Currency (Chamberlain Commission) was appointed in 1913. The Commission requested two of its members, Sir Earnest Cable and Mr. J.M. Keynes, to prepare a detailed scheme for its consideration. Mr. Keynes with collaboration of Sir Cable submitted to the

Commission on 'Proposals for the establishment of a State Bank in India'. Another memorendum on 'Proposals for the establishment of a State Bank for India' was prepared by Mr. L. Abrahams. Both the memorendums were in favour of the amalgamation of the three Presidency Banks. The Chamberlain Commission, which studied both the memorendums, stated in its Report that it was not in a position to report either for or against the establishment of a State Bank in India.

The actual decision of the amalgamation of the Presidency Banks was announced in the Indian Legislative Council in September 1919 by the Finance Member, Mr. H.F. Howard. The Imperial Bank of India Bill, providing for the amalgamation of the three Presidency Banks, was introduced in the Indian Legislative Council on March 1, 1920, and was passed in September 1920; the amalgamation came into effect in January 1921. Though the Imperial Bank of India was primarily a commercial bank, however, the bank was also entrusted with certain central banking functions. But it was not a full-fledged central bank in a true sense. It performed only two important central banking functions, in particular acting as banker to Government and to some extent, banker's bank. However, the other central banking functions, notably regulation of note issue and management of foreign exchange continued to be performed by the Government.

Meanwhile, the International Financial Conference held at Brussels in 1920 passed a resolution to the effect that 'in countries where there is no central bank of issue, one should be established.' The second conference convented at Genoa (1922) made a similar recommendation. Since the several countries setup central banks, for instance, South Africa (1921), Peru, Latvia and Lithuania (1922), Colombia (1923), Hungary, Poland, Australia and Uruguay (1924)[1].

The Royal Commission on Indian Currency and Finance (Hilton Young Commission) was appointed in August 1925. The Commission submitted its Report in July 1926 and strongly recommended the establishment of a central bank. The bank was to be called the 'Reserve Bank of India' and all central banking functions were to be entrusted to it.

To implement the recommendations of the Hilton Young Commission, 'The Gold Standard and Reserve Bank of India Bill' was introduced in the Legislative Assembly on January 25, 1927. After discussing the various clauses of the Bill, the Government of India published a new Gold Standard and Reserve Bank Bill in January 1928. The debate and considerations regarding the Bill continued, and from 1930-31 onwards,

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1. For other afterward world-wide establishment of the central banks, see M. H. De Kook, <u>Central Banking</u>, pp. 10-2.

the question of establishing a Reserve Bank for India received fresh impetus, in connection with the consideration reform for the country. The Report of the Indian Central Banking Inquiry Committee (1931) also strongly recommended the establishment of a Reserve Bank 'at the earliest possible date'. Meanwhile, a Departmental Committee was appointed in London by the Indian Office, under the chairmanship of Mr. H.A. Ment, to advise upon the nature of the Reserve Bank legislation. The Indian office Committee's Report was followed up by the appointment of another committee (London Committee) in London.

The Reserve Bank of India Bill, 1933, drafted on the basis of the recommendations of the London Committee, was introduced in the Legislative Assembly by the Finance Minister, Sir George Schuster, on September 8, 1933. The Bill was referred to a Joint Select Committee on September 13, 1933. The Bill was passed by the Assembly on December 22, 1933, and by the Council of State on February 16, 1934. The Bill received the assent of the Governor-General on March 6, 1934, and on April 1, 1935, the Reserve Bank of India started functioning[1].

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1. For a detailed discussion and main features of this long series of efforts to setup a central bank in India, see, History Of The Reserve Bank Of India (1935-51) (Bombay: Reserve Bank of India, 1970), pp. 1-39.

4.2. Role of the Reserve Bank of India

The importance of the Reserve Bank of India in context of the monetary policy arises because it is the central bank of our country.

A central bank comes into existence in order that the monetary system may be enabled to operate more acceptably than would be possible in the absence of a central bank. It is the changing financial and monetary environment and the inability to adjust to such changes by modifying the existing structure of laws and regulation that leads to dissatisfaction with the central-bankless society. The failure to achieve an automatic monetary system is why we have monetary management[1].

The preamble of the Reserve Bank of India Act, defined the objects of establishing a Reserve Bank for India as the regulation of the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage. It is for this purpose the Reserve Bank of India was established as a central banking institution. The main functions and responsibilities of the Reserve Bank of India has been classified into following

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1. C.R. Whittlesey, Lectures On Monetary Management, p.2.

broad categories: (i) to serve as banker to the Government, (ii) to issue notes, (iii) to serve banker to other banks, and (iv) to maintain exchange stability[1]. The Reserve Bank's role in the sphere of agricultural credit has also become its special responsibility.

While the exact wording may differ between one central bank and another, certain features can be credited as being almost universal elements in all central bank institutions. "A central bank may always be guided by the public interest, and must never be swayed by the profit motive. Its business is not, like commercial banks, to earn profits, for its shareholders, but to safeguard the stability of the monetary and credit system of the country"[2].

It is important to mention the basic factors that characterise the role of the Reserve Bank in the context of economic planning in India, as it is the traditional agent for carrying out monetary policy. India has accepted economic planning to achieve overall development with the acceleration of planning efforts, exceptional stress and strain developed in the economy which added extra responsibility of the Reserve Bank of India to formulate its monetary

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1. Reserve Bank of India, History of the Reserve Bank Of India (1935-51), pp. 98-9.

2. S.N. Sen, Central Banking In Underdeveloped Money Market (Calcutta : Bookland Pvt.Ltd., Third ed.,1961), p.8.

policy within the broad framework of development plans. The structure, nature, size and dimensions of the Five Year Plans, however, generally exceed the available financial resources. Therefore, the Government has to resort to large-scale deficit financing, which gives rise to inflationary pressures. In this respect, the objective of the Reserve Bank's policy has been to carry out the development plan and to maintain a reasonable degree of economic stability.

In such a background, the Reserve Bank has to assume dual responsibility in formulating its monetary policy. It has to maintain pre-determined pace of growth and at the same time it has to keep the inflationary pressures at the bay. Therefore, the Reserve Bank has to perform the twin role of a promoter as well as that of a regulation at the same time[1]. The regulatory aspect of monetary policy aims at controlling the inflationary pressures generated in the economy while production forces gather momentum, and the promotional aspect of the monetary policy aims at creating adequate amount of monetary resources for development process. Both of these roles of monetary policy are equally important for a developing economy. Monetary policy is expected not only to promote development but also to resist the forces which are likely

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1. Alak Ghosh, Control Techniques In Indian Monetary Management (Calcutta : The World Press Private Limited, 1971), p. 8.

to impede it. It has been well recognised that money supply and bank credit has to be expanded to meet rapidly increasing investment for purpose of development. This tremendous increase in monetary resources may take the form of deficit financing to provide sufficient funds to the Government. When deficit financing is undertaken, it may lead to the problem of inflation; and hence, credit policy should be one which aims at the prevention of bank credit for speculation and other undesirable purposes. But, at the same time, sufficient credit facilities should be made available for meeting the genuine credit needs of different productive sectors of the economy[1]. It has been also mentioned in the various Annual Reports of the Reserve Bank of India that the Bank attaches importance to "....the twin objectives of ensuring increased flow of credit to industrial and other developmental activities and of restraining undue expansion of credit for speculative and non-essential purpose"[2]. The

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1. A. Raman, "Monetary Policy During The Second Plan Period - Its contribution to the Achievement Of Economic Stability And Control Of Inflation", in Monetary Policy of The Reserve Bank of India, S.N. Sen (Rapporteur), Papers read at the Indian Economic Conference, Bombay, 1963 (Bombay: Popular Prakashan, 1964), p.190.

2. Reserve Bank of India, Report On Currency And Finance, 1957-58, pp. 25-6. Similar statements may be seen in the Reports of the Central Board of Directors also.

central banks in many developing countries are assuming positive leadership in building up an adequate credit system to carter to the such requirements of a growing economy.

In such a background, the monetary policy of the Reserve Bank of India has been designed to control inflationary pressures of a large credit expansion by employing the various monetary instruments, without denying an adequate supply to essential channels. Analysing such issues of 'expansion' and 'control', the Reserve Bank adopted a monetary and credit policy which came to be defined as 'controlled expansion' in the Budget Speech of May 15, 1957.

To conduct its policies on sound lines, the Reserve Bank of India is in possession of the various instruments of general and selective credit controls in its armoury under the different sections of both the Reserve Bank of India Act and the Banking Companies Act 1949. Being a banker to the Government, it has to conduct the financial and banking operations of the Government to fit into broader perspective framework and financial pattern of the Plans. Being a banker's bank, it has been granted statutory powers to control all the banking business. It is also empowered with the facilities of credit control. The techniques of the monetary policy employed by the Reserve Bank seek to regulate (a) the cost of credit, (b) the availability of credit, and (c) the purpose or use of credit. The control of bank reserves gives the

Reserve Bank a general power of control over the creation of credit. More specially, it is also empowered to determine the policy in relation to advances followed by banks, where it is satisfied that it is necessary or expedient in the public interest to do so. It is also empowered to determine policy regarding advances to be followed by banks and to give directions to banks as to purposes for which advances may or may not be made in respect of the secured advances and rates of interest to be charged on advances. To enable the Reserve Bank to control banking business, it has also been granted power to grant licence to banks, to conduct their annual inspection, and control their mergers and amalgamations.

As regards the promotional role of the monetary policy of the Reserve Bank of India, not only the banking development has been promoted to provide finance for different productive sectors of the economy during the economic planning in the country, it has also been instrumental in setting up a wide net work of financial institutions to divert national savings to desired sectors. It includes establishment and development of the commercial banks and the various other financial institutions of banking nature.

As regards the regulator role of the monetary policy of the Reserve Bank of India, it has made all efforts to strengthen the monetary controls and modified the various credit control instruments from time to time to check the

undesired expansion of the credit for unproductive and speculative purposes.

Therefore, in the context of existing inflationary pressures in the economy the responsibilities of the Reserve Bank of India have been rising to a greater extent. It is expected to employ greater control over the financial institutions of the country and thereby to direct the credit allocation among priority sectors and to restrict efficiently the flow of credit for hoarding and other anti-social speculative activities. Further, it is necessary for the Reserve Bank of India to formulate its policy of 'controlled expansion' more appropriately. The need for all round discipline among its various aspects is urgent in this context. Therefore, it has to be more realistic to increase the rate of non-inflationary saving and investment to control the process of continuous rising prices in the economy in order to achieve the ultimate goal of 'growth with stability'.

4.3. The Reserve Bank of India And The Government

The Reserve Bank of India as the chief monetary authority of the country is accepted to ensure an adequate degree of monetary management. But, there arise some problems of relation between Reserve Bank and the Government.

While introducing the Reserve Bank of India Bill, 1933, in the Legislative Assembly Finance Member, Sir George Schuster,

had explained in his speech that "....with the changing political situation, it is desirable that the control of credit in the country should be in the hands of an independent authority which can act with continuity....Further, the experiance of all countries is again united in leading to the conclusion that the best and indeed the only practical device for securing this independence and continuity is to setup a Central Bank, independent of political influence"[1].

But in actual practice, while trying to work independently, there are possibilities of conflict between the monetary authority or central bank and the Government. H.V.R. Iengar has given three good examples of such complicts[2].

In Canada, Mr. James Coyne was appointed as Governor of the Bank of Canada in early 1955 and his tenure of office was due to expire at the end of 1961. But on matters of policy relating to the heavy imports of American capital, there was a sharp difference of opinions between the Governor of Bank of Canada and the Minister of Finance. Therefore, after a very bitter debate between the two in Parliament and an enquiry by a Parliamentary Committee, Mr. Coyne was forced to resign from his post before the due date of expiry of his office tenureship.

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1. R.B.I., History of the Reserve Bank of India (1935-51), pp. 38-9.
2. See, H.V.R. Iengar, Monetary Policy And Economic Growth (Bombay:Vora & Co. Publishers Pvt.Ltd.,1962), pp. 281-3.

There was a case of conflict in July 1957 in Sweden. The Riksbank (the central bank of Sweden) increased the bank rate from 4 to 5 per cent without consulting Government. The Swedish Government felt offended and thought that the step was completely uncalled for and should, in any case, not have been taken without consultations with them. Subsequently, the Chairman of the Board of Directors of the Riksbank was forced to resign by the Prime Minister of Sweden. Similarly, resignation was also demanded from the Governor of the Bank. But he refused to resign on the ground that he was responsible only to Parliament. The conflict was subsequently resolved by the Riksbank undertaking to consult Government before making changes in the bank rate.

Yet another case of conflict was in U.S.A. when Mr. Marriner Eccles was the Chairman of the Federal Reserve in Washington. A controversy arose between President Truman's administration and the Federal Reserve about the policy underlying the Reserve's open market operations. Mr. Eccles had not agreed to the President's suggestions regarding open market operations and he subsequently resigned.

The above cases clearly show the fact that the maintenance of appropriate relations between a central bank and the Government is not always an easy task. It involves an adjustment of views and a mutual recognition of the role that each has to play in the national interest.

In context of the relations between Reserve Bank of India and the Government, C.D. Deshmukh had aptly said : "After all, it is not the theoretical constitution of the institution that matters, but the spirit in which this partnership between the Ministry of Finance and the Bank is worked"[1]. Prior to 1949, the relations between the Government, particularly the Ministry of Finance and the Reserve Bank were close, confident and even intimate. It was factual rather than legal. But, by the Banking Companies Act, 1949, the Government of India had established a legal connection between the two. Under the Reserve Bank of India Act also, provision was made for close cooperation between the Bank and the Government in vital policy-making spheres and for the exercise of a measure of the Government influence in the composition of the Directorate of the Bank, including chief executives, namely, the Governor and the Deputy Governors[2].

The Radcliffee Committee Report has also given some interesting observations on the relation between the central bank and the Government[3]. According to the Committee, though

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1. V.R. Mutalik Desai, Banking Development in India (Bombay: Manaktalas, 1967), p.58.

2. Reserve Bank of India, History Of The Reserve Bank Of India (1935-51), p.85.

3. "The Bank's Relationship with the Central Government, Radcliffee Committee Report, pars. 760-775, pp. 271-6.

there should be "constant cooperation, strategic and tactical", between the two but "...monetary policy and monetary operations and that the policies to be pursued by the central bank must be from first to last in harmony with those avowed and defended by Ministers of the Crown responsible to Parliament"[1].

Similar views were expressed by the Finance Minister of India in a statement in the Rajya Sabha on December 21, 1957. He said, "The Governor of the Reserve Bank is not an officer of the Government. The Reserve Bank happens to be the supreme autonomous body that is created....He is a non-official. He is entitled to criticise the Government, to differ from Government....We can, in matters where Government's policies are to be carried out, issue directives; but the Reserve Bank can hold a different opinion though they have to act according to the directives issued by the Government for good reasons....He is bound to carry out the direction but in doing so he is entitled to tell me and also publish it in his report that the Government of India was advised in this matter...."[2].

Therefore, in this respect the views of Radcliffee Committee and the Government of India are almost similar, and

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1. Radcliffee Committee Report, par. 767, p. 273.
2. H.V.R. Iengar, Monetary Policy And Economic Growth, pp. 294-5.

both hold that the Government is supreme and the central bank is bound to follow its advice and suggestions.

But, such a subordinate position of the Reserve Bank in its dealings with the Central Government reduces the administration and techniques of monetary policy. The feeling is often expressed, for example, that the Reserve Bank is altogether too passive a partner in the matter of deficit financing. Furthermore, provisions requiring financial institutions to hold a large proportion of their assets in the form of government securities are said to have resulted in a wholly artificial market for the bonds of different governmental bodies. In such an environment, central banking loses independence and effectiveness. And if there is too little independence, the central bank largely loses its reason for being[1].

Therefore, in pursuing the monetary operations, if the Reserve Bank is not independent, it is in danger of being merely a creature of the Treasury, and the advantages expected to come out from the existence of a detached expert body will be lost. In this case, it is not possible to accept the views of the Patman Committee (U.S.A.), which strongly holds that, "the independence of the Federal Reserve system is desirable, not as an end in itself, but as a means of

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1. C.R. Whittlesey, Lectures On Monetary Management, p.71.

contributing to the formulation of the best overall economic policy....The independence of the Federal Reserve System must be an independence within and not from Government"[1].

Therefore, in any case, the independence and autonomy of the monetary authority like the Reserve Bank of India is desirable for more effective working of monetary policy and implications of its instruments. Although there are different views regarding the appropriate relationship between the central bank and the Government, yet it is manifest that satisfactory working arrangements between the two can easily be established. For it, the Government must have confidence in the central bank and its Governor, and, in turn, the central bank must be concious that the Government is directly answerable to the people and recognise the Government's ultimate responsibility. Both the central bank and the Government should cooperatively help each other in using monetary operations in desired manner and directions in the national interest, and must have a watchful eye on the misuse of the monetary instruments.

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1. H.V.R. Iengar, Monetary Policy And Economic Growth, p. 267.

CHAPTER V

THE BANK RATE POLICY

5.1. The Concept of Bank Rate Policy

Bank rate policy, or the 'Discount rate' policy (as it is called in United States), is one of the most popular and traditional instruments of the central bank to imply its monetary policy. The Bank of England was the first bank to which developed the 'Discount rate' policy as an instrument of monetary control. Afterwards the Bank rate policy was adopted practically by other central banks allover the world.

The Bank rate is defined in Section 49 of the Reserve Bank of India Act 'as the standard rate at which it (the Bank) is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under this Act. It is the rate on advances by the Bank that is important and has been commonly treated as the equivalent of Bank rate. Viewed in the broad sense of the rate on the Bank's accommodation, the Bank rate so defined is of some significance since it forms the basis for the rates at which the Bank grants advances to various types of borrowers, including Government[1]. In other words, Bank rate is the rate charged

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1. Reserve Bank of India, Functions And Working, p. 41.

by the Central bank on discounts or advances to its member banks. Consequently, it measures for banks the cost of fund obtained from the Central Bank by such borrowings. Therefore, the Bank rate policy of the Central Bank seeks to influence both the cost and the availability of credit by changing the Bank rate. The cost of borrowing is affected directly by changes in the effective bank rate. "The conception underlying a Bank rate policy is that high interest rates tend to discourage borrowing while low interest rates tend to encourage it. Consequently by raising or lowering the Bank rate the authorities are in a position to cause an increase or a decrease in the quantity of money"[1].

The availability of credit depends largely on the statutory requirements regarding the eligibility of bills for rediscounting and securities as collateral for advances, as also the maximum period for which the credit is available. The statutory provisions regarding the grant of accommodation by the Reserve Bank of India to the scheduled banks are laid down in Section 17 of the Reserve Bank of India Act. Under this Act, the Bank's credit extension can take the form of rediscount of eligible bills or advances against eligible security[2].

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1. Paul Einzig, Monetary Policy : Ends and Means, p.273.
2. Reserve Bank of India, Functions And Working, pp. 41-2.

The Reserve Bank of India is empowered to grant loans and advances to scheduled banks under the provisions of some sub-sections of the Reserve Bank of India Act. But in practice, however, advances to scheduled banks have been made mainly under the three sub-sections of Section 17; against trustee (mainly Central Government) Securities[1]; since 1952 with the introduction of the Bill Market Scheme, against demand promissory notes executed by scheduled banks and supported by usance promissory notes of the latter's constituents[2] and; since 1962, against primissory notes of scheduled banks supported by export bills or, since 1969, by preshipment export credits granted by scheduled banks[3]. But, since the introduction of the Bill Rediscounting Scheme in November 1970, the Reserve Bank of India has been extending financial assistance to licensed scheduled banks by way of rediscounting of eligible bills of exchange in terms of Section (2)(a).

In addition to these credit facilities available in normal times, the Act provides, during occasions of emergency, for short-term loans being made by the Bank not only against eligible security but also against such other form of

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1. Reserve Bank of India Act, Section 17(4)(a).
2. Reserve Bank of India Act, Section 17(4)(c).
3. Reserve Bank of India Act, Section 17(3A).

security as the Bank may consider sufficient[1]. The intention of this section is to enable the Reserve Bank to make an advance to any bank, scheduled or non-scheduled, against any security acceptable to it, in times of emergency which might make it necessary for the Bank to advance or discount directly, notwithstanding the limitations imposed by conditions of eligibility[2].

In extending credit to scheduled banks, the Bank takes into consideration, apart from the general economic situations, not only the nature of the security offered to it, but also the general character of the operations of the applicant bank and the manner in which it is conducting its affairs[3].

The potentiality of the Bank rate policy is believed to be in two directions, i.e., it aims at regulating internal economic activities; and it serves as a regulator of international movements of short-term funds and through them to correct any disequilibrium in the balance of payments.

In developed countries the Bank rate is used primarily for the second purpose and only secondarily for the first purpose. Recently Bank rate is actively being used in developed countries to correct their balance of payments.

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1. Reserve Bank of India Act, Section 18(1)(3).
2. Reserve Bank of India, Functions and Working, p. 45.
3. Reserve Bank of India, Functions and Working, p. 47.

In developing countries the Bank rate is used mainly for promoting internal economic activities. Because of either non-existence or very low and imperfect development of money and capital market in such countries, Bank rate is not much effective to regulate the economic activities by regulating the cost of bank credit. But it promotes domestic economic activities by making credit available to the priority sectors of the economy. The Central bank can make credit available to various sectors by rediscounting the approved papers of commercial banks or special financial institutions established for that purpose. The necessary conditions to fulfil the second aspect of the Bank rate policy generally do not exist in developing countries. In India, since we lack a developed international market of short-term funds, the exchange restriction is usually used for correcting the balance of payments, in place of using the Bank rate policy for it.

Therefore, the traditional primacy of the Bank rate policy lies in the case of its effects on internal economic activities. The Bank rate which is itself is an interest rate, may be thought of at times as leading other rates. This is so when the discount rate is changed with a view to pushing interest rates in an upward or downward direction. At other times, the discount rate may be a follower rather than a leader of other interest rates. But, "the importance

of the Bank rate lies in the fact that it acts as a pace-setter to the other market rates of interest, both short-term and long-term"[1]. In United States of America, Federal Reserve Banks have frequently adjusted discount rates to bring them in line with market rates. The British tradition that Bank rate should always be above market rate implied that if market rates were to move substantially upward, Bank rate should also rise. Sometime ago the Bank of Canada announced the policy of maintaining discount rate at a quarter per cent above bill rate, to make the follower relationship fixed and official[2].

In none of these cases, however, is the discount rate policy to be considered passive or neutral. Even where the discount rate is adjusted to market rates it is intended to exert an influence on rates, if only through the assurance which is afforded by the existence of a lender of least resort prepared to issue credit at the official rate. The potentiality of more active intervention is always present.

The changes in Bank rate initiated by the Central Bank influences the economic process in various ways[3]. Firstly, a rise in interest rate penalizes investors, traders and other users of borrowed funds or credit. Rise in interest

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1. Reserve Bank of India, Functions and Working, p.49.
2. C.R. Whittlesey, Lectures On Monetary Management, p.42.
3. C.R. Whittlesey, Lectures on Monetary Management, pp.43-5.

rates increases cost for a commercial bank in the sense that it must pay a higher rate on rediscounts and advances or it must forego a larger return if earning assets are otherwise reduced to obtain reserves.

Secondly, interest rate changes may be considered not in the context of cost but of reward. Here the point of view is of the supplier of funds and not of the user. An increase in interest rates would encourage investors to forego consumption and make resources available for other purposes. It may also be a means of attracting foreign capital or of drawing them out of a position of inactivity or of relative inactivity within the country.

Thirdly, a change in interest rates may alter the availability of credit. An increase in discount rate would cause banks and other lenders to scrutinise loans outstanding. In essence, the Central Bank, by moving to tighten reserves, induces a closer rationing of credit. The availability of credit is reduced without any necessary increase in prevailing market rates.

Fourthly, change in interest rates involves a change in market quotations on fixed income securities. With a rise in interest rates the value of securities falls and with a fall in interest rates the value of securities rises. The shrinkage due to a rise in interest rates may be nominal only. With a change in interest rates, the change in market value

of assets alters the financial position of individuals and corporations holding the securities or assets. Therefore, the interest rates policy manifests itself in a very important manner.

Finally, any change in interest rates implies the psychological impact on lenders and borrowers. The attitude of businessmen and others may be influenced in the direction of greater venturesomeness or greater caution. This is conceptually different from the cost and reward aspects of interest rate changes, whereas a change in psychology is a change in attitude. A change in the interest rates may have quite a different effect from one which was expected. A rise in interest rates could be stimulative of borrowing rather than restrictive if it contributed to expectations of a further rise. Perhaps this is the reason due to which the inflationary trends continued unabated in the United States of America in 1955-56 even though the discount rate was increased five times within one year.

In these ways the Bank rate changes have usually been made for a variety of purposes as it brings changes in the rate of creation of credit, and through this in volume of investment, income and prices[1].

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1. S.N. Sen, Central Banking in Underdeveloped Money Markets, (Calcutta : Bookland Pvt. Ltd., 1967), p. 30.

Therefore, the Bank rate changes have had three-fold significance. First, they have reflected the Central bank's appraisal of economic trends; secondly, they have provided evidence of official determination to resist inflationary or deflationary pressures, expressed both internally or and through foreign exchange difficulties; and thirdly, they have served to influence — generally together with other monetary policy changes — the cost and availability of credit[1].

C.2. The Assumptions of Bank Rate Policy

The overall structure, working and effectiveness of the Bank rate policy depend on certain assumptions. These are as following:

i) Banks are the sole and important financial institution, and the commercial banks borrow from the central bank on an adequate scale[2].

ii) There is no long-term government debt in the economy.

iii) The fiscal authorities support the central bank completely.

iv) There is no excess liquidity in the economy outside the banks.

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1. Peter G. Fousek, Foreign Central Banking : The Instruments of Monetary Policy (New York, Federal Reserve Bank of New York, 1957), p.13.
2. Reserve Bank of India, Functions and Working, p. 48.

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1. Peter G. Fousek, Foreign Central Banking : The Instruments of Monetary, Policy (New York, Federal Reserve Bank of New York, 1957), p.13.
2. Reserve Bank of India, Functions and Working, p. 48.

v) There is perfect mobility of funds both from temporal and sectoral point of view.

vi) The money markets in the economy are fully integrated.

vii) Perfect scope for price level and wage level flexibi lity exist in the economy.

viii) The economy is closed.

But in real world, all these conditions do not exist at a time either in developing countries or in developed countries. In practice also, the effectiveness of Bank rate policy is challenged insofar as its effective implication depends on following prime assumptions:

i) The central bank stands ready to lend freely at the given Bank rate and uses no other rationing method.

ii) The commercial banks have no inhibitions against borrowing from the central bank[1].

iii) The changes in Bank rate are flexible and well in time.

5.3. The Role Of Bank Rate As An Instrument Of Monetary Policy in India

The traditional primacy of the Bank rate policy lies, however, mainly on the ground that it can bring desired changes in demand and supply of money and lonable funds and

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1. Lester V. Chandler, The Economics Of Money and Banking, sixth ed., 1948 (New York : Harper & Row, 1973), p.247.

thereby, can influence the savings and investment, which are the final determinants of income and employment. The mechanism of the Bank rate policy was thought to be very simple under Gold Standard. The mechanism was believed to work as "…. changes in the discount rate of the central bank would bring about more or less corresponding changes in local money rates generally, and that such changes in money rates would, through their operation on the supply of and demand for money and credit and on the international flow of capital, have the effect of readjusting the domestic levels of prices, costs, production and trade, and correcting any disequilibrium in the balance of payments"[1]. But, during the great depression of 'thirties' low interest rate had not shown such effects on various economic factors. The Discount rate policy was found ineffective in bringing about any prompt and decisive influence to reflect the basis of supply and demand conditions of equilibrium, but it also remained unable in creating any reflation of prices. Keynes, who had earlier rescued the Bank rate policy in 'early thirties', however, himself criticized it in 'late thirties' by stating that the "changes in interest rates were no longer capable of contributing materially towards the maintenance of equilibrium between saving and investment through regulating the quantity of money, as a condition of economic equilibrium"[2].

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1. M.H. De Kock, Central Banking, p.150.

2. J.M. Keynes, A Treatise on Money, vol. I (London: Macmillan & Co., 1930), p.185.

But Keynes ideas regarding the role of interest rate underwent a revolutionary change later on with the transition from 'Treatise on Money' to 'The General Theory of Employment, Interest and Money', in which he concentrated on the problem of under-employment equilibrium and expressed his concern over divergence between saving and investment.

The strong inflationary pressures during the Second World War period also brought change of opinion and Bank rate policy gained much importance in the prevailing conditions of worldwide inflation and the Government's inability to control it by non-monetary measures. The Korean War and inflationary consequences of devaluation have, further, increased the importance of Bank rate policy for regulating the monetary system. In recent time, both in developed and developing countries, the frequent use of this time-honoured instrument of monetary policy has been made very successfully. Moreover, in view of the non-feasibility in the application of another instrument like open market operations and inflexibility in case of variable reserve requirements, the Bank rate policy inevitably becomes the most significant instrument of monetary policy in developing countries[1]. Further, the past experiences regarding its effectiveness had also shown that the rate of credit expansion was checked

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1. Peter G. Fousek, Foreign Central Banking : The Instruments Of Monetary Policy, p. 27.

when the Bank rate was raised in Brazil, Costa Rica, El Salvador, India, Philippines and Peru. In the reverse case, when the Bank rate was lowered, the rate of credit expansion increased in El Salvador, Ceylon, Philippines, Thailand and Turkey.

It has now accepted that economic growth with stability can be achieved through Bank rate variations in developed countries also, though its effectiveness has suffered a good deal of controversy in these countries. The Radcliffe Committee reports that the immediate object of monetary action is to affect the level of total demand and the monetary actions may work upon total demand by changing the interest incentive, but only very limited reliance can be placed on this. While affecting the level of total demand, a variety of measures have to be taken into account, which will have inescapable directional effects[1]. It has come to be accepted that moderate changes of interest rate probably do not have a great influence on investment demand. An increase in the interest rate may tend to decrease short-term borrowing, but the influence of this factor is likely to be relatively small in a period of rising prices when the prospects for profit are high.

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1. Radcliffee Committee Report, par. 397, p. 135.

In a developing country like India, the effectiveness of the Bank rate policy as an instrument of monetary policy should apparently be less than in industrially developed countries with free private economies. The efficacy of Bank rate changes is important in respect of private sector. Indian economy is a planned economy with a large public sector and the Government is armed with large powers of direct regulation of investment. This investment is hardly influenced by the cost of credit or profitability. The demand for advances is not very sensitive to interest rates, but is dependent to a large extent, on the level of trade activity and the general attitude of the investors[1]. The effect of changes in the Bank rate is also largely dependent on the general prospect of the future course of prices. Moreover, the fixed investment in private sector also is not very much influenced by changes in the Bank rate directly, though probably this effect is more pronounced than in the public sector investment. Again, there are various direct physical means and a number of fiscal devices which may be used in order to check over-investment in the private sector. Further, there are

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1. Radcliffee Committee Report observes that "when we confined ourselves in making businessmen alter their decisions to buy or sell goods and services we were met with general scepticism" (par. 451) and "We have not found sufficient evidence to justify a conclusion that....the rise in interest rates would by itself have directly provoked to worthwhile curtailment of demand". Radcliffee Committee Report, pr.453.

pools of idle funds which are quite sensitive to interest rate variations and draw into active use when the interest rate is put up. Therefore, increase in the velocity of circulation of money offsets to some extent the restrictive effects of higher interest rate. Bank rate policy has also a doubtful and uncertain impact on the saving decisions and pattern of saving. In India, where three-fourths of personal saving is in insurance, housing, or small business, the impact of changes in interest rate is weak, as none of these is directly governed by the considerations of interest rate. Another factor which reduce the effectiveness of Bank rate policy is that the assumption that a rise in the Bank rate would increase short-term money rates is not always true to the facts[1].

Further, in the context of inflationary pressures in India during the planning period, the 'cost of credit' (as represented by the Bank rate) has only a secondary importance. The 'availability of credit' is more important, which has not been commensurate with the actual needs of the economy. This has also reduced the effectiveness of Bank rate policy in India.

Another important factor which decrease the role of Bank rate as an instrument of monetary control in India is

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1. D.Bright Singh, "Monetary Policy and Control of Inflation' in Commerce, Annual No. 2422, Vol. XV, December 1957, p. A-63.

that a large part of money market is 'unorganised'[1]. This 'unorganised sector', which is largely made up of indigenous bankers, money lenders, traders, commission agents etc., do not have any direct relationship with the Reserve Bank of India nor are they liable to its control and supervision. There are considerable inter-bank differences in lending and deposit rates. These rates have had little correlation with the Bank rate. Therefore, unorganised sector is virtually independent of Bank rate changes[2]. Therefore, the changes in the Bank rate have delayed and limited effect on the operations of this sector. Further, the 'organised sector' of the Indian money market is also not as well developed and sensitive as the money market of advanced countries. Bank rate changes in India do not cause sympathetic change in other short money rates even in the organised banking sector. Therefore, these two factors together decrease the role and efficacy of the Bank rate as an instrument of monetary policy in India.

Further, the Banking system in India directly under the control of Reserve Bank of India is extremely limited. Due to structural rigidities in the economy there are geographical and sectoral differences between rural and urban

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1. For details, see Chapter III entitled 'Indian Money Market'.
2. Manjula Bose, "Discount Rate Policy Of The Reserve Bank Of India", in The Monetary Policy Of The Reserve Bank of India, S.N. Sen (Rapporteur), p.25.

areas, or between industrial and agricultural sectors, or even between small cities and metropolitan cities. Such rigidities also effect the Reserve Bank's control over credit and reduce the potentiality of its Bank rate policy.

In India, the use of Bank rate policy has been neither active nor intensive in a bid to arrest the inflationary pressures. H.V.R. Iengar, former Governor of the Reserve Bank of India has frankly admitted that "....our attitude has been neither to discard the Bank rate instrument nor to use it as frequently as some of the developed countries of the West has done in recent years"[1]. In India, the Bank rate policy has been of little use or of no significance in controlling inflationary pressures in the economy caused by larger credit expansion. But, the monetary authorities in India still believe that the changes in Bank rate can control credit, stabilise prices, check inflation and promote economic growth. Sir B. Rama Rau, the former Governor of the Reserve Bank of India, however observed, "It is in the sphere of the private trading sector that the Bank rate can be more effectively applied when there is speculative hoarding of stocks with the assistance of bank advances in order to raise prices"[2].

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1. H.V.R. Iengar, Monetary Policy And Economic Growth, p.195.
2. Sir B. Rama Rau, Evolution Of Central Banking In India (Bombay : Vora & Co. Publishers Pvt. Ltd.,1960), p.53.

P.C. Bhattacharya, the then Governor of the Reserve Bank of India has also held the view "I believe, it is generally conceded that whatever limitations of the role of interest rate instrument as a regulator of overall investment, interest rates do have some influence....to the extent to which credit availability is made more difficult for such purposes (speculative inventory build up) and its cost raised whether by way of interest or by way of increasing margins, the object is to prune down such non-essential expenditures"[1]. H.V.R. Iengar, the former Governor of the Reserve Bank of India has also admitted that "The usefulness of the weapon of the Bank rate under Indian conditions is perhaps of greater significance in its impact on inventory accumulation, as a not inconsiderable amount of bank credit is utilised for that purpose"[2].

But, it would be misleading to argue that the changes in the Bank rate are out of place in Indian conditions. These conditions are themselves changing in India. The monetised sector is growing steadily and an extension of the organised money market is constantly taking place. Owing to the impact of massive investment plans, changes are also taking place in the demand for money and its supply with repercussions on

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1. P.C. Bhattacharya, Role of a Central Bank in a Developing Economy (Bombay : Vora & Co. Publishers Pvt.Ltd.,1968),p.57.
2. H.V.R. Iengar, Monetary Policy and Economic Growth, p.195.

the general structure of interest rates, both short-term as well as long-term. In a mixed economy, which is moving with some speed, it would be a mistake to adopt rigid attitudes on techniques of monetary control[1].

Therefore, in a country like India, the Bank rate policy has a positive role to play, where the rate of economic growth is dependent on the rate of savings and their investments in desired productive channels. The Bank rate can influence savings and investments through its effect of regulating demand and supply. Many countries of the world have increased their Bank rate in order to promote savings and economic growth. The different empirical studies done in India to find out the influence of interest rate changes on the demand for money and velocity of circulation, has also shown that there is some degree of responsiveness to the changes in the rates of interest[2]. In India, therefore, Bank rate policy can be of great significance. In the context of inflationary pressures, a positively articulated interest rate policy may serve as a potent weapon to contain inflationary potential, to mobilise resources and also to balance the external accounts of the country[3]. In inflationary

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1. H.V.R. Iengar, Monetary Policy and Economic Growth, p.195.

2. J.D. Sethi, Problems Of Monetary Policy In an Under-Developed Country : With Special Reference to India (Bombay: Asia Publishing House, 1961), p.46.

3. S.L.N. Simha, Essays On Finance (Bombay:Vora & Co.,1967), pp. 36-7.

situation, higher interest rate will act as a positive incentive to save and curtail consumption. Investment will not be affected adversely if psychologically an atmosphere of growth is kept up. A higher interest rate is also likely to achieve significant results in checking the inflationary rise of prices which is prevailing in India.

The Bank rate policy is capable in effecting the economic activities of private sector as well as in public sector. According to S.L.N. Simha, "....variations in the rate of interest are bound to produce some effect on the volume and pattern of investment, not only in the private sector but also to some extent in the public sector too, as a result of a more realistic reckoning of the cost of capital".[1]

Further, the unorganised sector of the economy is also itself dependent upon the organised sector of the money market on a growing scale. Therefore, impact of the changes in Bank rate is fairly effective in the unorganised sector also, specially when the direction is upward. Hence, in context of substantial increase in money and credit, it would be useful to use the instrument of Bank rate policy in order to reduce the supply of money and credit in the interest of price stability.

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1. S.L.N. Simha, Essays on Finance (Bombay : Vora & Co., 1967), pp. 36-7.

It is also argued that the Bank rate policy may not be effective when investments are financed from the internal sources. But, it may be said that variation in the Bank rate will have indirect influence on such business decisions.

5.4. Bank Rate Policy In Action

Experience with the Bank rate policy has been comparatively new in India as one of the major policy instruments for regulating credit and prices. Bank rate changes have been made relatively infrequently in our country.

The Reserve Bank of India fixed its first Bank rate at 3½ per cent. The announcement of the Bank rate was timed just before the day (July 5, 1935) fixed for the scheduled banks to lodge their statutory deposits with the Reserve Bank[1].

In November, 1935, the very first year after the establishment of the Reserve Bank of India, Bank rate was lowered from 3½ per cent to 3 per cent and remained unchanged at that level until November 1951. It was only on November 15, 1951, the Bank rate was raised for the first time in 17 years, from 3 per cent to 3½ per cent. This was simultaneous with discount rate changes in many other countries[2] following the Korean War

1. Reserve Bank of India, History Of The Reserve Bank of India (1935-51), p. 161.

2. "In the U.K., the Bank rate was raised from 2 per cent to 2½ per cent on November 8, 1951 after a period of nearly 20 years of stability (excepting a temporary rise on the

fn.contd...

boom (1950) and the deteriorating foreign exchange situation. In India, there was an excessive credit creation which continued even during the slack season. The expansion of credit was believed to have encouraged speculative investment in inventories which intensified the rising tendency of prices. Thus, the problems faced by the Reserve Bank at that time were 'three-fold'. In the first place, it was necessary to prevent further excessive expansion of bank credit without adversely affecting production and legitimate requirements of various sectors of the economy. Secondly, the Reserve Bank had to introduce a measure of credit control and thirdly, at the same time to impart an element of credit elasticity in the money market. This signalled a major change in monepolicy and led to an immediate increase in money rates by ½ per cent. With a view to making the rise in Bank rate effective and acquiring greater control over the money market, a change in the policy of Open Market Operations[1] was essential. A change in the Bank rate without any restraint on the scheduled banks to monetise public debt would have been fruitless. Therefore, the Reserve Bank of India declared that

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<u>fn.2 of previous page</u>

eve of the Second world War). The Bank rate was raised in other countries like Australia and New Zealand". D.H. Pai Panandikar, <u>Interest Rates And Flow of Funds (A Case Study : India</u> (Delhi: Macmillan, 1973), p.46.

during the ensuing busy season it would not normally buy Government securities, but would give advances against such securities, under Section 17(4)(a) of the Reserve Bank of India Act. This operated as a break on the monetisation of public debt. This meant a gradual retreat from the cheap money policy. This step of change in the monetary policy was followed by very soon by the Bill Market Scheme.

This rise in the Bank rate proved effective to some extent. The general index number of wholesale prices declined from 433.0 in November 1951 to 377.5 in March 1952 and it further declined to 367.1 in May 1952[1]. But, it does not indicate that the increase in the Bank rate was the only factor responsible for bringing down the inflationary rise of prices. Actually the general price level received a set-back due to several other monetary and non-monetary factors[2],

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1. For further details about the behaviour of Index Numbers of Wholesale Prices during 1951-52, see Reserve Bank of India, Report on Currency and Finance, 1951-52, Statement 16.

2. The recession in prices from the Korean peak was started by various factors, such as: (i) increased supply of several agricultural products, particularly cotton; (ii) decline in the demand for raw materials on the part of industries following as a reaction of the excessive over-stocking of such goods during the Korean flare up, (iii) Korean peace-move in mid-1951, (iv) the stretching out of the rearmament programme in the U.S.A., (v) the arrangement for orderly sharing of the scarce materials through the International Materials Conference, and (vi) a small budgetary surplus.

which were also designed to contain inflationary pressures in the economy. Actually, an increase in the Bank rate was the least effective measure that was needed at that time. The general price level had already started falling from middle of 1951. The general index declined by about 5.6 per cent from the peak of 462.0 on the 14th April 1951 to 436.2 on the 29th October 1951, the month before the adoption of the new monetary policy. The decline became precipitated since January 1952 when the full impact of the rise in the Bank rate and the change in the Open Market Policy began to be felt. Thus, by the middle of March 1952, the general index recorded a fall of 15 per cent from 428.8 on 26th January to 364.9 on the 15th March. It would have been more appropriate for the Reserve Bank to increase the Bank rate in the later half of 1950 at the time of outbreak of the Korean-War when the inflationary pressures started gathering momentum. Moreover, the action was delayed and rise in the Bank rate could not prove quite effective in improving the price situation to the extent that was needed at that time. But, the raising of the Bank rate, however, fulfilled the immediate objectives of preventing a large expansion of money supply during the busy season and of enabling the Reserve Bank to have more effective control on the volume of bank advances. The cautious lending policy of the banks also restricted the volume of credit and the scope of speculative trading. As a result, the bank credit

expanded to a lesser extent by Rs.99.96 crores during the busy season of 1951-52 as against Rs.180.29 crores during the busy season of 1950-51.

After a small rise of ½ per cent in the beginning of the First Five Year Plan, Bank rate remained unchanged for nearly 5½ years, i.e., from November 15, 1951 to May 16, 1957 due to two important causes: (i) the monetary authorities in India did not realise the necessity to restrict investment and expanded loans, and (ii) they were not aware of the fact that Bank rate could be used at a time, when private traders hoarded commodities for speculative purposes by taking loans from the banks. Thus, in the year 1955-56 within the First Five Year Plan period, the Indian economy experienced the largest absorption of money supply, witnessed the largest amount of investment outlay in the public sector and was administered the heaviest dose of deficit finance. All these factors combined together to swell the aggregate effective demand in the economy. Increasing consumption demand consequent on higher investment and incomes in the economy set against the shortfalls in foodgrains production and the scarcity of some commodities in the domestic market due to rise in their exports brought about the rise in prices. Also, as the formulation of the Second Plan was progressing, there was increasing awareness within the country that the rate of investment would be

substantially higher and that there would also be a much larger dose of deficit finance[1]. Therefore, the onset of the Second Five Year Plan with its greatly expanded programmes of investment necessitated an upward movement of interest rates. As a result, the Reserve Bank announced an increase in Bank rate from 3½ per cent to 4 per cent on May 16, 1957 with a view to check inflationary pressures and speculative demand of credit as the indirect taxes and excise duties were suspected to generate fresh inflationary pressures in the economy.

An important change took place in October 1960, when the Reserve Bank of India introduced for the first time a system of graded lending rates in order to raise the cost of borrowing and thereby reduce the demand for credit. According to this system, each scheduled bank was assigned a quota equal to half of the average amount of the statutory reserves required to be maintained by it during each week of the previous quarter. Any borrowing over this limit upto 200 per cent of the quota was made subject to bear a penal rate of 1 per cent above the Bank rate, and 2 per cent above the Bank rate for amounts above 200 per cent of the quota. At

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1. Pramod Kumar Mukherjee, Money Supply And Prices In India Since Independence (1947-1960) (Calcutta : The World Press Private Limited, 1966), p. 61.

the same time, in order to ensure the effects of stricter monetary policy, the Reserve Bank directed all scheduled banks to raise their average lending rate by not less than ½ per cent, and to maintain their minimum lending rate at 6 per cent on all advances. They were also directed not to pay interest at a rate higher than 2 per cent below the Bank rate on any deposit (other than inter-bank and saving bank deposits) repayable on notice of not more than 21 days or on the expiry of a period not exceeding 21 days from the date of deposit. This system was made effective from October 1, 1960[1].

The Reserve Bank modified this three-tier system of lending rates to a four-tier system in July 1962. It was designed to raise the average lending rate of the Reserve Bank by ½ per cent more. At the same time, the quota of borrowing for each scheduled bank was also reduced[2]. A

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1. H.V.R. Iengar, '*Monetary Policy And Economic Growth*, pp. 197-8.

2. The basic quota of each scheduled bank to borrowing at the Bank rate was reduced by one-half to 25 per cent of the average statutory reserves of the bank in the preceding quarter; borrowing equal to another 25 per cent of the average statutory reserves were to be charged a rate of 1 per cent above the Bank rate, those above 50 per cent and upto 100 per cent of the average statutory reserves a rate of 2 per cent above the Bank rate, and those above the statutory reserves a rate of 2.5 per cent above the Bank rate.
Reserve Bank of India, *Report On Currency And Finance, 1962-63*, p. 42.

revised system of lending rate effective from October 31, 1962 was introduced by fixing a ceiling to the total amount that could be borrowed by a bank from the Reserve Bank of India[1]. However, "The modifications in the slab rates as well as the general lowering up of interest rates in the money and capital markets underlined the need for adjusting the Bank rate in line with the prevailing pattern of interest rates"[2]. Therefore, with effect from January 2, 1963, the Reserve Bank raised its Bank rate from 4 per cent to 4½ per in order to formalise these progressive modifications. Simultaneously, the three-tier system of lending rates was also simplified into two-tier system[3] by merging the first

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1. Borrowing upto 25 per cent of the statutory reserves was to be charged at 4 per cent, and another 25 per cent at 1 per cent above than the Bank rate, i.e., 5 per cent, and remaining was to be charged at 6 per cent. However, it was indicated that the Reserve Bank could permit borrowing beyond this limit after making an assessment of the overall position of the borrowing bank and that such special accommodation would be at a higher rate of interest. Reserve Bank of India, Report On Currency And Finance, 1961-62, pp. 42-3.

2. Reserve Bank of India, Report On Currency And Finance, 1962-63, p.43.

3. Under the two-tier system banks were permitted to borrow the amount equal to 50 per cent of their statutory reserves at the Bank rate, i.e., 4½ per cent, and over 50 per cent at 1½ per cent above than the Bank rate, i.e. 6 per cent. Any borrowing beyond this limit was to be charged a higher rate.

two slabs in order to curb the expansion of credit to achieve price stability. Due to some drawbacks of the quota system, it was felt later that it would have been better, if the Reserve Bank of India had straight-way increased the Bank rate, instead of making a number of frequent changes in the quota system. Therefore, the quota system was liberalized in October 1963 and March 1964. The quota system was finally given up in September, 1964.

Another change of ½ per cent in the Bank rate took place on September 25, 1964, when it was raised from 4½ per cent to 5 per cent. At the same time, the quota-cum-slab rate system was also replaced by a differential system of interest rates, varying with the net-liquidity position of borrowing bank. This system which is known as the 'Net-Liquidity Ratio System', placed primary importance on effecting the cost rather than directly restricting the availability of credit from the Reserve Bank. The idea underlying this system was that the cost of borrowing credit from the Reserve Bank would progressive increase with a comparative decrease in net liquidity position of a bank and if the bank indulged in over extending its advances portfolio, it had to bear a penalty in the form of paying higher interest on its borrowing from the Reserve Bank. The minimum net liquidity ratio was fixed at 28 per cent. For every 1 percentage point decrease in this ratio, the rate charged on the entire amount of its borrowing from the Reserve Bank was to go up by ½ per cent. An important feature of this system

was the fixation of a ceiling of 9 per cent on the rate of interest which the Indian foreign banks with aggregate demand and time liabilities of Rs.50 crores and above and banks incorporated outside India could charge on their advances and usuance bills.

In order to control the inflationary pressures and to limit the tempo of credit expansion in the busy-season of 1965-66, the net liquidity ratio was tightened in February 1965. The required net liquidity position of a scheduled bank for providing the loans at the Bank rate was increased from 28 per cent to 30 per cent. For every increase of 1 per cent of a fraction thereof in the net liquidity ratio, the rate of interest on the entire amount of borrowing from the Reserve Bank was stepped up by ½ per cent. Therefore, during the busy-season of 1965-66, the rate of interest (except for some favoured sectors) rose to 1 per cent. The ceiling of 9 per cent was also increased to 10 per cent.

But,the price situation continued to remain unsatisfactory. Therefore, following the excessive price increases (instability due to excess demand), the Bank rate was used for the fifth time as a weapon of credit control on February 17, 1965, when for the first time, it was raised by 1 per cent, i.e., from 5 per cent to 6 per cent. The three main purposes for such an increase in the Bank rate were: (i) to check abnormal inflationary pressures, (ii) to curb the increase in

money supply, and (iii) to reduce the bank's reliance on the Reserve Bank's assistance.

In the pursuit of a higher interest rate policy, "it was decided to make greater use of the interest rate instrument both for restraining expansion of monetary demand and for promoting savings"[1]. Therefore, deposit rates and advance rates of the banks also underwent an upward revision. The State Bank raised its advance rate from 6½ per cent to 7 per cent in February 1965. The minimum advance rate was increased from 7 per cent to 8 per cent on February 17, 1965. The rate on advances to State cooperative banks for financing seasonal agricultural operations and marketing of crops under Section 17(2)(b) or 17(4)(a) or 17(4)(c) was raised from 3 per cent to 4 per cent. The rate on advances to state cooperative banks for financing the production or marketing of cottage and small-scale industries was raised from 3½ per cent to 4½ per cent.

But, during the year 1966-67, the Indian economy saw the signs of recession. To meet this situation, finance for the priority sectors was cheapened and the rate for them was decided to be 4½ per cent. Following the recessionary trend in the economy, Reserve Bank of India acted as in the monetary sphere

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1. Reserve Bank of India Bulletin, August 1965, p. 1000.

to make availability of credit a little cheaper in order to revive the economy and encourage capital formation. Therefore, the Bank rate was reduced from 6 per cent to 5 per cent on March 2, 1968. This announcement of cut in the Bank rate was first downward movement in the history of the Reserve Bank of India, if the initial adjustment to 3 per cent in December 1935, from 3.5 per cent is excluded. This reduction in Bank rate was accompanied by an allround downward adjustment in the interest rate structure.

The Reserve Bank justified this step as "in keeping with the overall policy to promote recovery and in view of the increase in agricultural output....the reduction in the Bank rate is desirable at the present juncture"[1]. The central budget for 1968-69 followed by the Bank rate reduction was also designed to stimulate the economy through relief in the corporate taxation and policy of budgetary deficit. Thus, both the Bank rate reduction and the budget emerged as parts of a coordinated policy, making use of both monetary and fiscal measures to help the private sector to encourage investment.

However, the reduction in the Bank rate was not justified due to many reasons. The argument of 'increase in

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1. Text of the Reserve Bank of India's Press Note announcing the reduction in the Bank rate - March 2, 1968.

agricultural output' through the Bank rate was not justified as the banking system was not financing the agricultural sector significantly[1]. Therefore, it was quite improper to argue that bank credit could help in increasing the agricultural production and could bring price stability. Nor did the Bank rate cut help the saver or the investor. Lower interest rate on deposits had lowered the level of savings. The cut is likely to reduce the attraction of state securities and loans for the investing public to pursuade it to look the corporate sector to mop-up its savings. The cut in the Bank rate will also not affect the secured advances which account for about 85 per cent of the bank advances on which most of the banks charge the interest rate between 9 and 9.5 per cent while the effect of the reduction in the ceiling on advance rates would be on the advances about 9.5 per cent. Clean advances, which accounted for about 15 per cent attract interest at 10 per cent. It is only the latter category that will become cheaper by a half per cent and all other advances shall be charged at the old rates. This reveals that while banks will be saving substantially in interest charges payable on deposits, their loss in interest earned on advances will not be significant. The cut in

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1. The share of scheduled bank's advances to agriculture amounted to Rs.56.64 crores, i.e., 2.1 per cent in March 1967, while that of industry, it amounted to Rs.1747 crores, i.e., 64.3 per cent of the total advances in the same period.

the Bank rate is, therefore, favourable to banks rather than savers and investors.

The Bank rate cut in 1968 was, therefore, a most untimely and unkindly cut indeed when the prices were increasing at double the growth rate of output, when the already low savings ratio had dropped, when the economy was just recovering from two droughts, stocks of grains being at meagre level, when the country had just devalued the rupee a year and a half ago on June 6, 1966 and when the post-devaluation problems remained the same as the devaluation problems[1]. Therefore, a lowering of the Bank rate at a time when there existed a need for arresting inflationary pressures stimulating savings, was premature and uncalled for.

It is true that the monetary policy of India during 1951-67 could not hold the price level but there is no doubt that the possibility of the inflationary price rise increases even more if credit creation is done arbitrarily. During 1968-69 and 1969-70 economy was relieved a little by excessive price rise. But, this was not due to the monetary discipline but due to record production of foodgrains following a bumper wheat crop in 1967-68. The Fourth Five Year

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1. P.R. Brahmananda, "Bank Rate : The Most Unkindest Cut", Commerce, March 9. 1968, p. 637.

Plan launched in April 1969 also aimed at carrying the country forward in the path of self-reliance by reducing dependence on foreign aid and accelerating the tempo of development in conditions of stability and reduce uncertainities. Together with programmes of increased agricultural production, the Plan provided for the building of sizeable buffer stocks to even out the supplies of food-grains and other measures to stabilise food-grain prices and the price level in general[1].

In the first half of the year 1970-71, bank credit was expanding at a faster rate than bank deposits[2] and therefore, commercial banks had turned increasingly, to the Reserve Bank for accommodation. During this period the general price level increased by about 5 per cent to 6 per cent above the level of a year ago. Therefore, the Reserve Bank of India once again stepped up the Bank rate from 5 per cent to 6 per cent on January 9, 1971, which took it back

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1. Government of India, Fourth Five Year Plan, 1969-74, par. 1.30.

2. Money supply with the public had increased by 13 per cent to Rs.6791.10 crores in the calendar year 1970. This increase has been the result of a larger credit expansion by the commercial banks. Bank credit rose to Rs.547 crores at the end of March 1969 as against a rise in aggregate deposit by Rs.636 crores. But at the end of 1970, bank credit outpaced the deposit growth, aggregate deposits rose to Rs.798 crores against a rise in bank credit by Rs.812 crores.

to the level prevailing prior to March 2, 1968. The bank rate was increased mainly to impose a degree of restraint on credit expansion. With a view to check the mounting inflationary pressures and to impart a greater restriction on credit expansion, the net-liquidity-ratio was also again tightened simultaneously. The minimum net-liquidity-ratio for accommodation at Bank rate was now fixed at 34 per cent for every percentage decline in this ratio, the Reserve Bank's accommodation became dearer by increasing the rate charged to 1 per cent from the floor level of the Bank rate. This time the Reserve Bank had also fixed the maximum penal rate of 15 per cent on all excess borrowing by banks. To mobilise additional deposits by making them more attractive in terms of interest rates, the Reserve Bank allowed the scheduled commercial banks to increase the ceiling rates on various categories of deposits by ½ per cent to ¼ per cent. In other words, the Bank rate rise was an step to restrict credit and to mobilise to the maximum extent possible deposits from the public to control inflationary pressures in the economy. The immediate impact of these changes which had done after a careful review of prevailing monetary and price situation, was considerable reduction in the rate of expansion in bank credit.

During the year 1971-72 liquid conditions had developed and the demand for credit was not such as to introduce for any major change in Reserve Bank's general credit policy specially in refinance policy.

In view of the persistent pressure on prices arising from the imbalance between aggregate demand and supply and the overall liquidity position of commercial banks, the Reserve Bank of India's credit policy for 1972-73 busy season was designed to siphon off the excess liquidity with the banks at the time to enable banks to assist production, particularly in respect of the crash programme of rabi production and in the industrial sector. Therefore, banks' statutory liquidity requirement which was last raised to 29 per cent on August 4, 1972, was further raised to 30 per cent on November 17, 1972. Also as a regulatory measure the minimum net liquidity ratio relevant for determining the rate of banks' borrowing from the Reserve Bank of India was raised from 34 per cent to 36 per cent. However, the Reserve Bank did not modify its basic structure of refinance for specific purposes.

The demand for credit showed some signs of picking up during the first quarter of 1973 and, thereafter, the pace of credit expansion accelerated. A mid-season appraisal revealed an expansion in credit by March 9, 1973 of Rs.721 crores (i.e. 13.8 per cent) as against an increase of Rs.314 crores (i.e., 6.5 per cent) in the busy-season of 1971-72. Such severe pressure on prices and the imbalance between money supply and output called for a restraint on further credit expansion. Therefore, in March 1973 the Reserve Bank increased the net-liquidity ratio from 36 per cent to 37

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per cent. The borrowing rate was also increased. For the first percentage point decline or fraction thereof in net liquidity ratio (i.e., below 37 per cent), the borrowing rate was increased from 6 per cent to 8 per cent (i.e. 2 percentage point). Thereafter, a fall in the rate of one percentage point or fraction thereof there was made an increase of one percentage point in the borrowing rate. This time the maximum penal rate on all excess borrowing was lowered from 15 per cent to 12 per cent. This was applied to net liquidity ratio of 33 per cent and below.

In context of prevailing inflationary price situation and anticipated shortage of a number of important agricultural commodities, it was considered necessary to further tighten the liquidity position in the banking system in order to bring down the rate of credit expansion as well as price rise. Therefore, on May 30, 1973 the Reserve Bank of India adopted package of measures including increase in Bank rate from 6 per cent to 7 per cent. The main objectives of these measures were to control refinance facility of the Reserve Bank and to curtail the lendable resources of banks.

In July 1973 the Reserve Bank of India discontinued its concessionary refinance facility with some exceptions. The cash reserve requirements were further raised in two stages. In following, net liquidity ratio was also increased to 40 per cent. For every percentage point fall or a fraction

thereof in the net liquidity ratio below this level, the rate of interest increased by one percentage point above the Bank rate when it fell below 36 per cent the maximum rate of 12 per cent was charged. But, this maximum penal rate of borrowing was increased from 12 per cent to 15 per cent w.e.f. November 16, 1973. These steps were taken with a view of imposing maximum credit restraint. To further tighten the credit expansion, the Reserve Bank of India advised the banks to keep in close check and minimise their lending. The banks were instructed that their total credit expansion in all sectors other than food procurement during the period ending September, 1973 and April 1974 should not exceed 100 per cent of the end-September, 1973 level. The Reserve Bank of India also imposed a ceiling in respect of individual bank's total borrowing from the Reserve Bank on November 30, 1973.

Despite the maximum possible tightened measures of the Reserve Bank, the credit expansion continued of substantial order. During the busy season of 1973-74 the borrowings of banks from the Reserve Bank and their credit expansion substantially crossed the limits prescribed by the Reserve Bank. Further, the bank credit increased in sizeable proportion due to higher demand for credit while the rate of deposit accretion slowed down. Therefore, the Reserve Bank decided to increase interest rates on savings and term deposits w.e.f. April 1, 1974 with a view of encouraging savings.

The price increase, which continued unabated, despite the bumper kharif harvest in 1973-74, was the outcome of an excessive imbalance between the annual rate of growth in the stock of money and in the stock of basic consumption, and related production necessities[1]. During the end of 1969 and the third week of January 1974, money supply had increased by 70 per cent, the level of wholesale prices by 60 per cent and of the food articles by 62 per cent. The general index of wholesale prices which was 262.0 in December, 1973 (Base 1961-62 = 100) increased sharply in the first week of July 1974 to 315.3, thus recording an increase of about 19 per cent. Therefore, with a view to check such inflationary upsurge of the bank credit, the Reserve Bank of India for the first time in its history announced the two percentage increase in the Bank rate from 7 per cent to 9 per cent on July 22, 1974. Simultaneously the rates of interest on loans and deposits on commercial banks were also levered up. The minimum lending rate of banks was increased from 11 per cent to 12½ per cent. The maximum rate chargeable by the Reserve Bank was also increased from 15 per cent to 18 per cent. The net liquidity ratio which had touched its highest level of 40 per cent in July 1973 was reduced to 39 per cent in

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1. C.N. Vakil, War Against Inflation : The Story of the Falling Rupee, 1943-77 (Delhi, The Macmillan Company of India Ltd., 1978), p.143.

September 1974. But the maximum rate charged on borrowings from the Reserve Bank continued at 18 per cent. A further increase in the effective lending rate followed the imposition in August 1974 of a tax of 7 per cent on the interest income from bank loans, which further pushed up the cost of credit by about 1 per cent.

With a view to regulating the cost and the availability of refinance more effectively, the system of relating refinance to net liquidity ratio of banks was discontinued from November, 1975.

With no abatement of the pace of monetary and credit expansion in following years, a package of measures to help contain inflationary pressures was announced on July 11, 1981. The Reserve Bank of India, as a part of its anti-inflationary package, increased the Bank rate by one per cent, from 9 per cent to 10 per cent. It also raised the statutory liquidity ratio from 34 per cent to 35 per cent in two phases, 34.5 per cent from September 25, 1981 and 35 per cent from October 30, 1981.

Experience with the Bank rate policy in the concerned period (1951-1981) reveals several characteristics. The variations in the Bank rate of the Reserve Bank of India has been indicated in the following Table No.4.

Table : 4

Variations in the Bank Rate of the
Reserve Bank of India

Date of Change	Effective Bank Rate (Per cent per annum)	Variation (Per cent per annum)
Before 1951	3	-
November 15, 1951	3½	+ ½
May 16, 1957	4	+ ½
January 2, 1963	4½	+ ½
September 25, 1964	5	+ ½
February 17, 1965	6	+ 1
March 2, 1968	5	- 1
January 9, 1971	6	+ 1
May 30, 1973	7	+ 1
July 22, 1974	9	+ 2
July 11, 1981	10	+ 1

It is obvious from the above Table that the Reserve Bank of India has been trying to check the inflationary pressures of prices and credit expansion through the Bank rate in a hesitating manner. Since the year of the beginning of the First Five Year Plan in 1951, the Bank rate had varied only ten times in the thirty years of planning in India. This shows that the instrument of Bank rate policy has not

been used in India as frequently as in some of the other developed countries[1].

It may be said that during the period 1951-52 to 1980-81 the instrument of Bank rate policy proved effective only upto some extent. This is the reason that the Reserve Bank of India had to adopt the policies of quota-cum-slab rate system and net liquidity ratio system to make the Bank rate policy more effective.

Two features strike as to the use of Bank rate in India. First, every time there has been a change in the Bank rate, it has been marked up except once in March, 1968 when it was lowered. Second, each time the mark up in the Bank rate has been a small extent of ½ per cent or 1 per cent except once in July 1974 when it was increased by 2 per cent. The first policy feature arises from the belief that an increase in the Bank rate is a sure way of curbing the expansion of credit. The second feature, namely, that the Bank rate has been raised by very small percentage, follows from the recognition that a big rise may be too strong a dose, which may produce a

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1. "Inbetween the years 1951 and 1957, Bank rate had varied only twice, once in November, 1956 and then again in May 1957. This is sharp contrast to a change of Bank rate of 9 times in the U.K., 10 times in the U.S.A., 9 times in Canada and 10 times in Belgium during the same period". Manjula Bose, "Discount Rate Policy of the Reserve Bank of India" in <u>The Monetary Policy Of The Reserve Bank of India</u>, S.N. Sen (Rapporteur), p.28.

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crisis, followed by a slump, which is perhaps worse than the original malady[1].

But, every time when the Bank rate was raised to check credit expansion and to control inflationary pressures, the result has been the comparative ineffectiveness. Since 1951, the credit advances by the scheduled banks continued to expand abnormally and aggravated the inflationary pressures in the economy. Actually, the raising of the Bank rate did not have any effect in bringing down the upward trend of price by restricting the undue credit expansion in the economy. As shown in Table 5, during the period 1950-51 to 1980-81 when the Bank rate increased from 3 per cent to 10 per cent, discounts and 'other loans and advances' by the Reserve Bank to the scheduled commercial banks amounted to Rs. 3162.0 crores and Rs. 889.0 crores respectively at the end of March, 1981, while the credit advances by the scheduled banks went up to Rs. 25270.0 cror at the end of March, 1981.

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1. D.N. Gurtoo, "Reserve Bank of India's Monetary Policy And Certain Live Issues in Monetary Economics", in The Monetary Policy Of The Reserve Bank of India, S.N. Sen (Rapporteur), p.127.

Table : 5

Loans, Advances And Re-discount Of The Reserve Bank of India

Rs. in crc

Year*	Other Loans & Advances **	Bills purchased and discounted	Total scheduled Banks' credit
1950-51	12.41	8.12	422.42
1960-61	94.53	30.17	1319.54
1970-71	368.37	38.00	4684.00
1980-81	589.00	3162.00	25270.00

* As at the close of last Friday.
** Loans and advances other than those to Government
Source: Reserve Bank of India Bulletins (Monthly)

This is also notable that the scheduled banks are lar ly independent of the Reserve Bank for their credit operatic and have financed them mostly without borrowing or re-disco- unting from the Reserve Bank. The commercial banks have developed the habit of maintaining sufficiently large cash reserves and have thus acted as their own 'central bank'. It may be seen from Table 6 that the aggregate deposits of the scheduled commercial banks increased from Rs.880.61 crores at the end of 1950-51 to Rs.37,847.0 crores at the end of 1980-8 The proportion of borrowings to the deposits which was 1.4 per cent in 1950-51, increased to 2.76 per cent in 1960-61 but having declined to 2.4 per cent in 1968-69, it stood to 6.2 per cent in 1970-71 and declined to 1.56 per cent in

Table : 6

Changes in the Scheduled Commercial Banking Business

(Rs. Crores)

At the close of last Friday of	Aggregate Deposits	Borrowings from the Reserve Bank of India	Total cash in hand and balances with the Reserve Bank of India	Investment in Government Securities	Percentage of (2) to (1)	Percentage of (3) to (1)	Percentage of (4) to
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1950-51	880.61	12.41	93.30	350.34	1.41	10.59	39.78
1951-52	882.05	54.13	78.75	359.90	6.14	8.93	40.80
1955-56	1043.15	65.08	84.73	312.71	6.24	8.12	29.98
1956-57	1175.30	103.16	88.26	307.03	8.78	7.51	26.12
1957-58	1451.24	42.00	105.04	400.14	2.89	7.24	27.57
1958-59	1636.01	61.86	107.76	570.12	3.78	6.59	34.86
1959-60	1902.02	79.44	152.91	672.88	4.18	8.04	35.38
1960-61	1746.06	94.53	116.58	558.58	5.41	6.68	31.99
1961-62	1921.87	53.04	123.46	601.39	2.76	6.42	31.29
1962-63	2042.26	71.28	125.71	592.76	3.49	6.16	29.02
1963-64	2285.10	84.16	147.60	639.59	3.68	6.46	27.98
1964-65	2576.99	153.02	161.75	718.18	5.94	6.28	27.87
1965-66	2949.83	73.52	170.80	810.69	2.49	5.79	27.48
1966-67	3425.51	139.72	215.62	892.80	4.08	6.29	26.06
1967-68	3855.98	103.91	221.34	967.03	2.69	5.74	25.08
1968-69	4338.18	105.65	274.85	1054.61	2.43	6.34	24.31
1969-70	5028.19	238.02	321.88	1166.83	4.73	6.40	23.20
1970-71	5906.17	368.37	363.96	1362.31	6.24	6.16	23.06
1971-72	7106.93	207.45	447.30	1650.29	2.92	6.29	23.22
1972-73	8643.14	138.45	486.87	2161.25	1.60	5.63	25.00
1973-74	10139.33	408.52	855.66	2362.11	4.03	8.44	23.30
1974-75	11827.15	472.72	907.66	2826.43	3.94	7.67	23.90
1975-76	14022.80	798.43	915.88	3236.15	5.69	6.53	23.08
1976-77	17566.00	967.00	1500.00	3930.00	5.50	8.54	22.37
1977-78	22211.00	331.00	2143.00	5907.00	1.49	9.65	26.59
1978-79	27016.00	546.00	3191.00	6621.00	2.02	11.81	24.50
1979-80	31759.00	739.00	4250.00	7444.00	2.33	13.38	23.44
1980-81	37847.00	589.00	4848.00	9079.00	1.56	12.81	23.99

Source: Reserve Bank of India Bulletin, various issues of corresponding years.

1980-81. This has, however, made possible for the scheduled banks to multiply their cash reserves at a rising rate. Even fall in the ratio of their reserve to deposits means that the multiple by which their credit in relation to reserve can expand, becomes higher. Moreover, the scheduled banks' investment in Government securities have increased from Rs. 350.34 crores in 1950-51 to Rs. 9079.0 crores in 1980-81, while the investment-deposit ratio declined from 39.7 per cent in 1950-51 to 23.99 per cent in 1980-81. These increased investments in Government securities have increased the capacity of scheduled banks to acquire at balances with the Reserve Bank and thereby add to their basic reserves and expand credit. In other words, the scheduled banks can 'monetize' the investment and use them to strengthen to base for credit expansion.

It may, however, be observed that during the planning period, there has been substantial increase in the financial resources and cash position of the scheduled banks in India. In this way, the banks were able to expand credit to the extent indicated above. The Reserve Bank of India has raised its Bank rate eight times during thirty years of planning but what could it do if the scheduled banks were not dependent on the Reserve Bank and financed their resources themselves. It has been observed that investment-deposit ratio has been falling continuously, while credit-deposit ratio has increase

from 62.1 per cent in 1950-51 to 70.3 per cent in 1979-80. The remarkable progress and the growth in the volume of large cash reserves and maintenance of liquidity by the scheduled commercial banks on the one hand, and the higher expansion in bank credit on the other hand, have made it possible for the banks to ignore any change in the Bank rate The ineffectiveness of the Bank rate may, therefore, be taken as a foregone conclusion on the fact that commercial banks more and more, due to their self-sufficient position, did not need to borrow from the Reserve Bank. Therefore, the Reserve Bank was in no position to impose desired discipline on the scheduled banks through changes in the Bank rat at which it was prepared to grant them loans. After raising of Bank rate from 3 per cent to 3½ per cent in November, 195 commercial banks' borrowings fell from the level of Rs. 64.13 crores in 1950-51 to a mere Rs. 18.87 crores in 1952-53. Then, after the second change in the Bank rate in May, 1957, borrowings declined from Rs.103.16 crores to Rs. 42.0 crores. After stiffening the lending terms in October, 1960, borrowings declined from Rs. 94.93 crores to Rs. 53.04 crores and again after the upward changes in the Bank rate in September 1964 and February, 1965, it fell from Rs. 163.02 crores in 1964-65 to Rs. 73.52 crores in 1965-66. Again, when Bank rate was raised in January, 1971, borrowings declined significantly from Rs. 368.37 crores in 1970-71 to Rs. 207.45 crores in 1971-72. Although the increase in Bank rate in May, 1973

and July, 1974 was totally ineffective in restraining banks' borrowings from the Reserve Bank. Instead of declining they increased from the level of Rs. 408.52 crores in 1973-74 to Rs. 472.72 crores in 1974-75 and to Rs. 798.43 crores in 1975-76 (See Table 7).

Table : 7

Scheduled Commercial Banks' Borrowings from the Reserve Bank of India

(Rs. in cro

Year*	Amount	Year*	Amount
1950-51	12.41	1965-66	73.52
1951-52	54.13	1966-67	139.72
1952-53	18.87	1967-68	103.91
1953-54	31.07	1968-69	105.68
1954-55	37.07	1969-70	238.02
1955-56	65.08	1970-71	368.37
1956-57	103.16	1971-72	207.45
1957-58	42.00	1972-73	138.45
1958-59	61.86	1973-74	408.52
1959-60	79.44	1974-75	472.72
1960-61	94.53	1975-76	798.43
1961-62	53.04	1976-77	967.00
1962-63	71.28	1977-78	331.00
1963-64	84.16	1978-79	546.00
1964-65	163.02	1979-80	739.00
		1980-81	589.00

* As at the close of last Friday.

Source: R.B.I., Report On Currency And Finance, various issues of corresponding years and R.B.I. Bulletin.

It may, however, be seen from Table 8 that Bank rate changes do influence the lending operations of commercial banks. The decrease in the credit deposit ratio from 67.4 per cent in busy season of 1951-52 to 61.1 per cent in the busy season of 1952-53 was the impact of increase in the Bank rate in November, 1951. Impact of the increase in the Bank Rate in May, 1957 was that this ratio fell from 63.6 per cent in 1957-58 to 60.3 per cent in 1958-59. After increase in Bank rate in September, 1964 and in February 1965, the credit deposit ratio was reduced from 80.1 per cent in 1964-65 to 76.9 per cent in 1965-66. Again, when Bank rate was increased by 1 per cent in January 1971, the credit deposit ratio slipped down by 6.3 per cent, i.e., it declined from 78.0 per cent in 1970-71 to 71.7 per cent in 1971-72. The increase in Bank rate in May, 1973 could not reduce the credit deposit ratio of commercial banks in 1973-74 as compared with the ratio of previous year. But, this was mainly due to the slower pace of deposit accretion and higher rate of credit expansion. Moreover, the step of increase in Bank rate was delayed by one or two months on the part of the Reserve Bank in announcing its measures[1]. But, when the Bank rate was increased in July, 1974 the credit deposit ratio marginally declined to 72.2 per cent

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1. S. Joshi, "Failure of the Reserve Bank's Credit Policy" The Economic Times, April 4, 1974.

in 1974-75 as compared with the ratio of previous year when it was 73.7 per cent. Therefore, the increase in the cost of credit seems to have induced the desired effect of reducing the demand for credit. These were only year 1962-63 and

Table : 8

Variations In Credit Deposit Ratio of all Scheduled Commercial Banks

Year (Busy Season)	Credit Deposit Ratio	Year (Busy Season)	Credit Deposit Ratio
1950-51	65.4	1965-66	76.9
1951-52	67.4	1966-67	77.1
1952-53	61.1	1967-68	79.4
1953-54	64.7	1968-69	78.0
1954-55	64.9	1969-70	79.4
1955-56	71.2	1970-71	78.0
1956-57	74.5	1971-72	71.7
1957-58	63.6	1972-73	70.3
1958-59	60.3	1973-74	73.7
1959-60	58.6	1974-75	72.2
1960-61	68.3	1975-76	76.9
1961-62	72.6	1976-77	77.2
1962-63	76.1	1977-78	70.6
1963-64	79.6	1978-79	69.0
1964-65	80.1	1979-80	70.3

Source: R.B.I. 'Report On Currency And Finance', various issues of corresponding years.

1973-74 when both banks' borrowings from the Reserve Bank and credit deposit ratio showed rising tendency. But, "if the credit curbs, by themselves, are found ineffective in checking inflationary pressure, it is because the latter are not the result of monetary factors alone. If the new credit control measures do not succeed in curbing inflation, the Reserve Bank can hardly be blamed for this"[1].

But, while the present rise in the Bank rate has undoubtedly made the credit costlier and scarcer, it has failed to control inflationary pressures in the economy. It was feared in the business circles that the rise in the Bank rate would lead to a rise in the cost of production which would be passed on the consumers in the prevailing situation in the seller's market. It has, therefore, been argued that this would add inflationary fuel and the whole purpose of controlling inflation through dearer money would be nullified.

The continuous rising price level shows that the changes in the Bank rate were not effective enough to restrain the expansion of credit which is a major factor of inflation in India. The efficacy of Bank rate changes depend to a great extent on the responsiveness of interest rate structure. According to Keynes also, if the change in the official rates does not alter the market rates, we will say, it is ineffecti

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1. Shrinivas, "Implications of Ceiling on Credit Expansion", <u>Financial Express</u>, December 7, 1976.
2. J.M. Keynes, <u>A Treatise on Money</u>, p.201.

In other words, if the rise or fall in Bank rate does not lead to a rise or fall in the market rates, it is an indication of the ineffectiveness of the Bank rate policy in an economy. Then, it will not fulfil the objective of monetary policy to increase or decrease the quantity of credity and thereby bring desired changes in savings and investment. Hence, the objective of growth with stability will not be achieved through the instrument of Bank rate policy. Therefore, in an inflationary context it is necessary for the monetary policy to see that the interest rate does not rise so that cheap use of credit does not increase the inflationar pressures in the economy.

The structure of interest rates and its variations are not totally governed by the Bank rate in India but are marginally related to the Bank rate changes. Unfortunately, in this country, Bank rate has long since ceased to be a pace setter. "The Bank rate appears to have been more a follower and less a leader of the Indian money market. The few increases that it has undergone reflect more an attempt to prevent it from getting out of step with the rest of interest rate structure than to determine that structure in the light of the fundamental requirements of the economy"[1]. Actually,

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1. P.D. Hajela, Problems Of Monetary Policy In Underdeveloped Countries : With Special Reference to India, pp. 126-7.

the problem is not one of lowering or rising of interest rates, it is one of operating an integrated interest rate structure which takes into account the diversified needs of the economy[1].

In developed money markets, the gap between money rates is quite negligible and rates do not change from season to season and place to place. But, in an under-developed country like India, the interest rate structure has some peculiar feature of its own. The commercial banks rates and bazar rates, generally move in arbits of their own and it is they, not the Bank rate, which determine the terms on which credit can be obtained by most borrowers. In fact, the interest rate structure in India is not integrated at all.

It may be observed from Table 9 that there prevails a wide range of interest rates in India. In the organised sector, where some uniformity may be expected, interest rates on different types of loans do not follow the same pattern. The State Bank of India's discount rates for three month's bill has no functional relationship with the same bank's advance rate for demand loans. The rates on the three month's treasury bills of the Government follow still

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1. G.P. Gupta, The Reserve Bank of India and Monetary Management, p. 205.

another pattern. The yields of the various securities on the stock exchanges have a slightly greater organic unity, though even here it is far from complete[1].

In the bazar sector or in unorganised money market in India, interest rates diverge widely over different areas even for the same type of loans. The bazar bill rate, i.e., the rates at which bills of small traders have been discounted by Shroffs vary from one place to another. The rates charged by money lenders are still higher and vary from urban to rural areas. Besides this, the deposit rates of commercial establishments are also higher than those of banks. Therefore, there exists diversity in deposit rates also within the unorganised sector in India.

It may, therefore, be stated from the above discussion that the problem of the interest rate structure in India is that of difference in rates due to lack of integration among the various components of money market. There is not the same incentive as in most integrated system, to transfer funds from areas of low interest rates to areas of higher interest rates. There is kind of immobility here which is a part of the generalised immobilities

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1. K.N. Raj, The Monetary Policy of the Reserve Bank of India, p. 41.

that characterise an underdeveloped economy. In the absence of an integrated system, the differences in interest rates will prevail in India. The existence of such a diversified structure of rates of interest in the money market testifies the extent of unorganised money market in India. This limits to a great extent the capacity of the Bank rate to function as the principal regulator of credit and it leaves the Reserve Bank in a very prejudicial position. It has been officially admitted that "Unlike in many countries Bank rate changes in India are sympotmetic of fundamental stiffs in the pattern of interest rates and that is why changes are necessarily infrequent"[1].

It may, however, be seen from Table 9 that Bank rate changes do influence some short-term money rates in India. From 1950-51 to 1980-81 along with the raising of Bank rate from 3 per cent to 9 per cent, call money rate of scheduled commercial banks have increased from 1.25 per cent per annum to 7.12 per cent per annum in Bombay and from 0.5 per cent per annum to 8.28 per cent per annum in Calcutta, while Hundi rate and Advance rate even of the State Bank of India have risen from 4 per cent per annum to 13.0-15.0 per cent per annum and from 3.5 per cent per annum to 16.5 per cent per annum respectively during the same period. The bazar rates have also increased from 9 per cent per annum to 17.0-21.0

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1. <u>Reserve Bank of India Bulletin</u>, August, 1961, p.1226.

As on the close of last Friday of	Reserve Bank's Bank Rate	Scheduled Commercial Banks' Call Money Rate		State Bank of India		Bazar
		Bombay	Calcutta	Hundi Rate	Advance Rate	Bombay
1950-51	3.0-3.5	1.25-0.5	0.5	4.0-3.5	3.5	9.0-8.25
1955-56	3.5	2.75	3.16	4.5-5.0	4.0	10.5
1960-61	4.0	4.24	4.30	5.25-6.5	4.5-5.0	9.0-12.0
1961-62	4.0	4.24	4.14	6.5	5.0	10.5-12.0
1962-63	4.0-4.5	4.16	3.91	6.5-7.0	5.0	10.5-12.0
1963-64	4.5	3.87	4.0	7.25	5.0-6.0	12.0
1964-65	4.5-5.0	4.01	4.48	7.25-9.75	6.0-7.0	12.0
1965-66	6.0	6.26	6.81	9.25-9.75	7.0-7.5	12.0-15.0
1969-70	5.0	4.30	4.15	9.5	7.0	15.0
1970-71	5.0-6.0	6.38	6.91	9.5	7.0-8.5	15.0
1971-72	6.0	5.16	4.29	8.75-10.5	8.5	15.0
1972-73	6.0	4.15	3.70	8.75-10.5	8.5	15.0
1973-74	6.0-7.0	7.83	8.84	8.0 -13.0	8.5-9.0	15.0-17.0
1974-75	7.0-9.0	12.82	14.24	9.5-16.5	9-13.5	17.0-21.0
1975-76	9.0	10.55	11.12	14.0-16.5	14.0	-
1976-77	9.0	10.84	10.71	14.0-16.0	14.0	-
1977-78	9.0	9.28	7.12	13.0-16.0	14.0-13.0	-
1978-79	9.0	7.57	7.96	13.0-15.0	13.0	-
1979-80	9.0	8.47	8.50	13.0-15.0	13.0-16.5	-
1980-81	9.0	7.12	8.28	13.0-15.0	16.5	-

Source: Reserve Bank of India Bulletin, various issues of corresponding years.

er cent per annum in Bombay and from 10 per cent per annum to 15.0-19.5 per cent per annum in Calcutta markets in 1974-75. However, "this may be due to the high Reserve Bank commands in the market and also to the large statutory powers given to it by the Banking companies Act of 1949. There is reason to believe that the Reserve Bank of India is truly regarded by the commercial banks as the leader of the money market and its policy always has announcement effects. The commercial banks immediately feel which way the wind blows"[1].

The Reserve Bank's role in an inflationary situation with economic growth as an objective, is two-fold. Firstly, it should reduce the pressure of monetary demand. Secondly, it should not permit reduction in credit to the productive sectors of the economy. Money should be made tight but not at the expense of production. Inflationary pressures must be put under check, while production should be permitted to expand. There is a little controversy regarding the cheap money and dear money policy.

The Reserve Bank of India has once again followed a policy of dearer money since July, 1981 when it stepped up the Bank rate from 9 per cent to 10 per cent, at which level it stands today. Actually, it is the dear money not the cheap

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1. Hirendra Nath Roy, The Role Of Monetary Policy In Economi Development, p.96.

money which can reflect the scarcity value of the capital in the economy. If the cost of capital is not brought into a reasonable alignment with its scarcity value, it shall be an extremely difficult task to allocate productive resources efficiently and properly. It shall create monetary chaos - a paradise for speculators. In such a situati "Speculation could raise commodity price so much that speculators might like to borrow more money to buy stock of commodities. This rush for increased demand for credit might occasion a rise in the rate of interest. Thus, not only may the rate of interest not decline when the quantity of money has increased, it may actually go up because peopl are trying to satisfy their speculative motive. In any case there is no reason to deny that the demand function for money may be such that a part of increased quantity of money exercised an impact upon prices which is independent of the impact emanating from increased investments and increased marginal and average costs of production. If excess money is absorbed only through adjustments in the rate of interest and in the volume of real investments, one may not fear the consequences of cheap money policy since prices would be at best rise to the extent of the rise in average and marginal costs of production. But if that adjustment takes place even partly through demand induced rise in prices, cheap money policy would almost unavoidably lead to the emergence of inflationary conditions"[1].

1. P.D. Hajela, Problems Of Monetary Policy In Underdevelop Countries: With Special Reference to India, p.57.

In August 1947, Mr. C.D. Deshmukh said in the Governor's Report that "having considered all facts of the subject, I was inclined to think that a consolidation of the progress already made towards cheap money was very essential before making any attempts further to cheapen money.....It is being increasingly recognised that beyond a certain limit, cheap money not only ceases to be beneficial but in certain conditions, for instance when inflation outlives forces that engendered it, becomes positively harmful to the economy". But, however, it must be abundently clear by now that there has been a tendency in India to place too much emphasis on the concept of cheap money. This attitude was reflected in the Reserve Bank's hesitation to raise the Bank rate in an open and straight-forward manner. In forty-six years since the Reserve Bank of India was setup in the country, there have been only nine upward revisions in the Bank rate. And each time the rate has been raised by just ½ or 1 per cent except once by two per cent increase in July 1974. In any case, raising the Bank rate by ½ per cent to 1 per cent per annum would not discourage the demand for credit for speculative hoarding purposes when such investments were yielding between 2 per cent to 3 per cent per month[1].

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1. J.D. Sethi, *Problems Of Monetary Policy In An Under-developed Country : With Special Reference to India*, p. 234.

Sir B. Rama Rau, the former Governor of the Reserve Bank of India also argues, "....I doubt if under Indian conditions a slight increase of the rate can have any appreciable influence on the inflationary situation"[1]. Moreover, it has been the policy of the Reserve Bank to introduce the Bank rate weapon through the back door by evolving the techniques of graded or multiple lending rates and then formulating the rise in the structure of interest by increasing the Bank rate, the whole process being explained as adjustment of the Bank rate in the light of trends in the money and capital markets.

In a country like India, where the money market is not well organised and outrates are all higher, the Bank rate should always be put higher and there is hardly a case for making money cheap through a cut in it. With the lowering of the cost of borrowing, speculative hoarding may ultimately increase which may generate a new phase of inflation in the economy. Therefore, in the present day Indian economic conditions the "....interest rates should be realistic rather than pegged at low levels. Pegging at low level generally jeopardizes monetary stability....An appropriate interest rate policy will make the Government cost-consciou

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1. Sir B. Rama Rau, Evolution Of Central Banking in India, p. 49.

and investment decisions will correspond to its rate of return. Interest rates pegged at low levels are likely to result in over-investment and misallocation in view of the economy's factor endowment. A higher interest rate may encourage a higher rate of voluntary saving, desirable for economic growth. In short, realistic interest rates are essential for economic stability, efficient allocation of resources and possibly, a high rate of economic growth"[1]. D.R. Khatkhate also argues, using a flow of funds approach to monetary policy, that a high interest rates policy applied to the organized credit market would reduce the cost of investment by channellizing a greater part of savings into investment through financial assets[2].

But, in period of inflationary pressures, high interest rates do not automatically reduce either the supply of financial resources or the demand for them. To carry out the Bank rate policy successfully, it is necessary for the Reserve Bank of India to obtain greater control over the flow of money and credit. Therefore, the high Bank rate has to be supplemented by strict credit restrictions.

The Indian experience shows that even a dearer money policy, which was pursued from July 1974, could not deal with

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1. R.J. Mody, <u>New Dimensions Of Monetary Management</u>, p.115.
2. D.R. Khatkhate, "Analytic Basis of the Working Of Monetary Policy in Less-Developed Countries", <u>I.M.F. Staff Papers</u>, November 1972, p. 553.

the problem of an excessive price rise. The Wholesale Price Index have registered a continuous upward trend. Thus, under such circumstances, even a 10 per cent Bank rate was not enough for curbing the inflationary situation. Even this high Bank Rate could not discourage the borrowers to increase the amount of money from the scheduled banks. Neither it could curb hoarding and speculative tendencies associated with inflation. Therefore, after discussing the pros and cons of both cheap money policy and dear money policy on Indian context Alak Ghosh suggests that "....India, at present requires neither a full-fledged dear money policy nor the traditional type of cheap money policy. We should take a middle course of action and pursue a policy of flexible interest rate and this will be in conformity with the Reserve Bank's overall policy aiming at controlled monetary expansion"[1].

In the context of prevailing inflationary pressures, the monetary policy has the objective of ensuring condition of stability. A hesitant use of the Bank rate can hardly be expected to serve the purpose. Any reluctance to raise the Bank rate could positively due to the fear that "....a higher Bank rate would raise the cost of Government borrowings..."[2] and the value of Government securities would also

1. Alak Ghosh, Central Techniques In Indian Monetary Management (Calcutta: The World Press Pvt.Ltd.,1971), p.33.
2. Sir B. Rama Rau, Evolution Of Central Banking In India, p.52.

decline. But, this fear is more imaginary than real, as the rate of interest on Government securities is in no sense of representative price for capital in India[1]. Moreover, the major proportion of Government securities is held by the Government itself and the Reserve Bank of India. A rise in the cost of public borrowing would, therefore, be in a "nature of fictious book debt"[2]. Therefore, for several categories of security holders "fall in security prices should not occasion any serious problem"[3].

From the above study of Bank rate policy in India, it appears that the "....infrequent use of Bank rate proves that the Reserve Bank did not attach much importance to Bank rate as an instrument of its policy"[4]. Though the Bank rate policy has not succeeded to bring out desired results in context of growth and stability, yet, despite of its limitatio[ns] still it is an important tool of monetary policy in India. This instrument should be employed along with other instrument[s]

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1. T.T. Sethi, Price Strategy in Indian Planning (New Delhi, 1970), p.124.

2. S.K. Basu, "Presidential Address To the Forty-Sixth Annual Conference of the Indian Economic Association", The Indian Journal of Economics, January 1964, p. 264.

3. P.D. Hajela, Problems of Monetary Policy In Underdeveloped Countries With Special Reference to India, pp.135-7.

4. Nalinkumar I. Almaula, Operations Of The Reserve Bank of India (1935-1954) (Bombay: Asia Publishing House, 1960), p.184.

in a coordinate manner to enhance the Indian monetary policy effective, as the Bank rate policy "....is an absolute necessity for the sound management of a monetary system and that it is a most delicate and beautiful instrument for this purpose"[1]. Therefore, in order to facilitate growth with stability, the pattern of Bank rate policy will have to be applied in a more positive direction. A positive Bank rate policy is highly useful and desirable in a developing economy like that of India.

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1. Macmillan Committee Report, p.97.

CHAPTER VI

OPEN MARKET OPERATIONS

As analysed in earlier chapter, the Bank rate policy by itself is not a very powerful instrument of monetary policy. The shortcomings and ineffectiveness of the Bank rate as an instrument of credit control has led the Reserve Bank of India to rely to a greater extent on open market operations as a further means of credit control at its disposal. The policy of open market operations which the central bank can undertake on its own initiative, assumes considerable importance. In this chapter attempts have been made to examine the scope and role of open market operations in the context of monetary policy, as an important instrument of monetary regulation in the armoury of the Reserve Bank of India.

6.1. Meaning And Concept Of Open Market Operations in India

In a broader sense, open market operations may be said to cover purchases and sells by the central bank in the market not only of Government securities including Treasury bills, but also a variety of assets such as gold, foreign exchange, commercial bills and, in rare cases even corporate securities or company shares. In actual practice, however, they are confined only to the purchase and sale of Government securitie

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1. Reserve Bank of India, History Of The Reserve Bank Of India (1935-1951), p. 165.

both short-term and long-term. In most of the developing and developed countries the open market operations are conducted mostly in Government securities, because in the matter of Government securities the degree of initiative by the central bank is greater. But, in the respect of gold or foreign exchange, the volume of transactions largely depends on various exogenous factors. The initiative in the purchase and sale of foreign exchange does not lie with the Reserve Bank. The initiative for fixing the rates of exchange lies with the Government, and the initiative for purchasing or selling foreign exchange lies with the commercial banks. Therefore, the extent of purchases of foreign exchange as well as their timing are outside the control of the Reserve Bank. Therefore, to include purchases and sales of foreign exchange under open market operations is to stretch the meaning of open market operations too far[1]. On the other hand, Government securities are more prominent in the portfolio of commercial banks, financial institutions and even individuals, than any other asset. Therefore, these are more sensitive to changes in interest rates and capital value. Moreover, Government securities have an active and reversible market. Due to all these reasons most of the central banks' open market operations are confined to the Government securities as the normal medium of such operations. In the United

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1. Nalinkumar I. Almaula, <u>Operations Of the Reserve Bank of India (1935-1954)</u>, pp. 144-5.

Kingdom, United States of America and some other developed economies, with all organised and developed money markets, the term 'open market operations' generally refers to the intervention by the central bank on its own initiative in the Government security market and outright purchase or sale of Government securities. In some of the underdeveloped countries, where the Government security markets are not a well developed, attempts have been made to make the scope of open market operations somewhat wider by authorising the central banks to issue their own securities in the market and to conduct outright purchase and sale of such securities alongwith the Government securities[1]. In Korea the Bank of Korea Act authorizes its central bank in a period of necessity to issue, sell and buy in the open market special negotiable obligations of its own[2].

Though the financial markets in India are not as developed as the markets in United Kingdom and the United States of America but these are quite broad and active to enable the Reserve Bank of India to buy and sell Government

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1. Alak Ghosh, Control Techniques In Indian Monetary Management, p.35.
2. Byong Kuk Kim, "Central Banking In Korea", in Central Banking In South And East Asia, ed. S.Gethyn Davies, p. 101.
   Similar provisions are found in Ceylon, Ecuador, Paragua Phillipines and many other Latin American countries.

securities in appropriate amounts without much price fluctuations. It is generally believed that the Indian money market, though not closely integrated, is much better developed than the money markets in most of the Latin American and South East Asian countries[1]. In India, there are fairly active markets in Government securities at Bombay, Calcutta and Madras. Since an active market for Treasury bills does not exist in India, open market operation are conducted entirely in Government bonds[2].

With a view to effecting variations in the monetary position, the central bank by conducting open market operations, can regulate the flow of credit and bring about desired expansion or contraction of money and credit and the pattern of interest rates which in turn will have corresponding effect on the general economic activity. According to De Kock, "....purchases or sales of securities by the central bank tend directly and immediately to increase or decrease the money supply and the cash reserves of the commercial banks; that an increase or decrease in the supply of bank cash and, therefore, in the credit creating capacity of the commercial banks, tends still further to increase or decrease the quantity of money; and that changes in the quantity of

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1. Reserve Bank of India Bulletin, June 1960, pp. 797-8.
2. The Reserve Bank of India, Function and Working, p.56.

money tend not only in themselves to bring about the desired adjustments in the domestic levels of prices, costs, production and trade, but also through their effect on changes in money rates and credit conditions which, in turn, tend to operate in the direction of the desired adjustments"[1]. These operations are usually integrated with a central bank's loans and discounts policies which are intended to bring about desired changes in the flow of credit and in the pattern of interest rates.

However, the open market operations of the Reserve Bank of India have been used more to assist the Government in its borrowing operations and to maintain orderly conditions in the Government securities market than for influencing the availability and cost of credit. The objective of what is called 'grooming' the market, such as acquiring securities nearing maturity to facilitate redemption, and to make available on top a variety of loans to broaden the gilt-edged market have been more prominent in the conduct of open market operations in India[2]. An unique feature of open market operation policy in India relates to the attempts made by the Reserve Bank to augment the reserves of commercia banks in times of monetary stringency (during busy season)

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1. M.H. De Kock, Central Banking, pp. 180-1.
2. H.V.R. Iengar, Monetary Policy And Economic Growth, p. 200.

and provide them with an outlet for investment (during slack season)[1]. This amounts to saying that the resulting effects of purchase and sale of Government securities by the central bank may, therefore, be four-fold:

i) to assist the Government in their debt management and borrowing programmes;

ii) to provide seasonal finance to commercial banks;

iii) to create and maintain a desirable pattern of yielding on Government securities; and

iv) to control the reserve base of the banking system.

It shows that open market operations may be used for many purposes by a central bank. In general, they can be used to expand or contract credit at the initiative of the central bank. Thus, these operations can be directed for stabilising prices and promoting a economic activities by influencing quantity, ownership, maturity pattern of public debt and interest rate structure.

However, open market operations have been used as the main instrument for influencing the availability and cost of credit in the countries with the well developed and closely integrated financial markets; while in a country lik

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1. Sid Mittra, A New Horizon In Central Banking, p. 111.

India where financial system is not well developed, these operations have been used primarily to broaden the Governmen security market so as to create an institutional framework appropriate for flexible monetary policy and treasury debt management.

6.2. Open Market Operations In Other Countries

The method of open market operations was first employe in United Kingdom by the Bank of England during the thirties of the nineteenth century, and was also frequently referred to as 'borrowing in the market' and 'selling Consols (Consoli dated Government stock) spot and buying for the account'[1]. The Bank of England at first used open market operations as a supplementary instrument to make Bank rate effective, i.e., at times when the Bank considered it necessary to bring rates closer to Bank rate or to adjust market conditions to a change which it was about to make in Bank rate.

The only other central bank which undertook some form of open market operations prior to 1914 was the Reichsbank Germany. In the United States of America, when the Federal Reserve System was established, it was also authorised to open market operations. Burgess emphasised that open market operations found their major use as one of the most effecti

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1. M.H. De Kock, Central Banking, p.177, that is further taken from W.T.C. King, History of the London Discount Market (Routledge, 1936), p.166.

instruments of the Reserve System in its efforts towards creating monetary conditions which would favour economic stability[1].

In course of time, the technique of open market operations attracted a great deal of attention in various other countries. Though the role, scale of operations and emphasis of the open market operations vary from country to country, yet it has been recognised as one of the major instruments of the monetary policy in many developed as well as developing countries.

In 1938 the Bank of France was empowered by the decree of the President to undertake open market operations. In Holland, the subject of open market policy was discussed in 1936 and under the new charter as amended in 1945 it was given the power to buy and sell Government bonds, Treasury bills and bankers' acceptances, and this power was also incorporated in the new Bank Act of 1948. In Norway, an amendment was passed in 1936 which empowered the Bank of Norway to carry out open market operations. In Belgium, the National Bank was expressly authorised in 1937 to carry out the open market policy. In Hungary the National Bank was empowered in 1938 to make purchases and sales on the open

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1. M.H. De Kock, Central Banking, p.192, that is further taken from W.R. Burgess, Reserve Banks And The Money Market (Harper, 1936), pp. 249-54.

market calculated to direct and regulate the money market and the capital market. In Denmark, the National Bank had started conducting the open market operations during the thirties. In Sweden and Switzerland arrangements were made for special securities to be issued by the Government for the purpose of absorbing the excess liquidity.

The need for some form of open market operations as an instrument of monetary stabilisation was similarly felt by many of the new central banks which were established later on. The Bank of Canada was empowered to "buy and sell in the open market from or to any person, either in or outside Canada, securities, cable transfers, bankers' acceptances, and bill of exchange....".[1] In Cuba, National Bank's charter gives it the authority to purchase and sell Government securities[2]. In the forties and fifties similar powers were also granted to the central banks of Ecuador, Philippines, Ceylon, Japan, Mexico, Netherlands, Indonesia, Korea, Malaya, Paraguay, Pakistan, South Africa, Argentina, Guatemala, Costa Rica, El Salvador, Chile and Egypt for the employment of open market operations with a view "....to reinforce changes in official discount rates and bring about the desired changes

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1. Donald Bailey Marsh, "Canada" in Banking System, ed. Benjamin Haggot Backhart, p. 151.

2. Philip J. Glaessner and G. Sterling Grumman, "Cuba" in Banking System, ed. Benjamin Haggot Backhart, p. 216.

generally in short or long term interest rates or both; to absorb an excess of liquid funds or relieve an undue credit stringency; to insulate the internal credit structure from sudden and temporary movements in the balance of payments; to neutralize movements of Government funds and seasonal movements generally; and to maintain orderly conditions in the money and gilt-edged markets, in general"[1].

6.3. Open Market Operations Versus Other Instruments of Monetary Policy

It will be appropriate to compare open market operations with other instruments of monetary policy available to a central bank for exercising monetary regulation and control. Central banks in almost all the countries show marked preference for open market operations as against the instruments of Bank rate and variable reserve requirements.

The Bank rate and open market operations both affect the level of bank reserves. Bank rate, however, produces its impact indirectly through changes in the cost of acquiring the reserve through borrowing from the central bank. Whereas, on the other hand, open market operations strike at the reserve base directly. Moreover, while the Bank rate policy "depends only on its indirect influence on money and credit through primary changes in money rates and secondary repercussions on long term interest rates or yields, x open market

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1. M.H. De Kock, Central Banking, p. 205.

operations are designed to have a direct and immediate effect on the volume of money and credit as well as on interest rates generally to the extent that operations are conducted in both short and long term securities"[1]. In addition to it, the open market operations may be used either to supplement the effectiveness of the Bank rate or independently, within moderate limits, to narrow the gap between Bank rate and market rates, to induce banks to move in step, to avoid the psychological difficulties of changes in the Bank rate etc.[2]

Open market operations possess a degree of superiority over Bank rate policy because of the fact that in the case of open market operations the initiative is in the hands of monetary authorities, while in the case of Bank rate policy the effectiveness depends upon the response of commercial banks and their customers to change in the Bank rate. The non-banking financial intermediaries, engaged in borrowing and lending operations and now completing with the commercial banks, are also more amenable to control with the instrument of open market operations[3].

There has been also considerable controversy over the relative merits of open market operations and variable reserve

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1. M.H. De Kock, Central Banking, p. 181.
2. S.K. Muranjan, Modern Banking In India, p. 307.
3. Joseph Aschheim, Techniques Of Monetary Control (Baltimore The John Hopkins Press, 1961), p. 16.

ratios[1] which is another major instrument of monetary policy. But, in some aspects, the instrument of open market operation seems to be more appropriate than the variable reserve ratios William McC Martin gives various reasons in its favour[2]. Mart argues that a major difference between the two is that a chan in reserve requirements affects every member bank directly an immediately with equal force, irrespective of differing individual conditions whereas the effects of open market operations are felt individually and gradually by the member banks through the operation of market forces. Moreover, changes in reserve requirements are not at all impersonal in the extent to which they affect the competitive position of different types of banks. In U.S.A., they affect directly only member banks of the Federal Reserve System. Non-member banks which are subject only to State-imposed reserve require-ments are left untouched unless the State requirements are varied automatically with those of member banks.

When resort is made to the open market instrument, the reserves are removed through an impersonal market transaction. The actual absorption of reserves from the market results from the sale of securities to a willing buyer. Thus, the

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1. This instrument of monetary policy has been explained in detail in Chapter VII.

2. William McC Martin, Jr., "Reserve Requirement Changes Versus Open Market Operations" in Monetary Economics : Controversies in Theory and Policy éd. Jonas Prager (New York: Random House, 1971), pp. 239-41.

first impact of an open market operations comes about because a transaction has been effected between a willing buyer and a willing seller, rather than as a result of a change in an official regulation in case of variable reserve requirements.

While Bank rate changes are made occasionally and variations in reserve requirements much less frequently, open market operations can be carried out as a continuous process on a day to day basis. Moreover, the open market operations lend themselves much more readily than do changes in reserve requirements to achieving changes in the availability of reserves on even the smallest scale. They can be used readily to provide or withdraw reserves in amounts down to figures as small as the denominations of the securities that are traced. Changes in reserve requirements, on the other hand, normally change the availability of reserves by very much larger amounts because they are made as percentages of very large sums.

In context of the relative importance of the various instruments of monetary policy, the above discussion seems to conclude that open market operations "provide a continuously available and flexible instrument of monetary policy for which there is no substitute"[1]. But, however, it does not imply

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1. Reserve Bank of India, History Of The Reserve Bank of India (1935-1951), p. 165.

that open market operations are intended to entirely do away with the Bank rate and variable reserve requirements. In fact, these methods of credit control should not be regarded as substitutes but as complementary with each other. Open market operations may be used to make the Bank rate effective or to prepare a ground for a change in it. The sale or purchase of securities in open market should be accompanied by lowering or raising of the reserve requirements for healthy lending activities in some specific sectors of the money market. An effective coordination and a proper combination of these instruments is necessary for orderly market conditions and ideal policy of monetary regulation.

6.4. Conditions For Effective Functioning of Open Market Operations

The effective functioning of open market operations depends upon certain factors. The legal and institutional setting of open market operations must be favourable for its effective implication and regulating the flow of credit in an economy.

First of all, existence of a broad and active market for Government securities is necessary in the country. By fulfilling this condition the central bank can exert the influence by buying or selling securities on a considerable amount in order to affect the cash reserves of the banks. It is also necessary to check serious fluctuations in security

prices. Open market operations can be carried out successfully only when the money and capital market is broad and active. But fulfilment of this condition depends on certain institutional factors which is not easy to set right. "It is possible that open market operations themselves help to widen the capital market but we evidently can not go far with that, because, in the ultimate analysis, building up of a capital market can only result from economic development"[1].

Secondly, commercial banks should follow the policy of maintaining more or less a fixed ratio between their cash reserves and the deposit liabilities. If the cash ratio is stable, the central bank can be reasonably certain of the effects of its open market operations on credit conditions.

Thirdly, while reducing the reserve base of the commercial banks, central bank should not allow easy access to the rediscount window, otherwise the gains from open market operations would be neutralised by easy borrowing from the central bank[2].

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1. P.D. Hajela, Problems Of Monetary Policy In Underdevelope Countries : With Special Reference To India, p. 152.
2. P.D. Hajela, Problems Of Monetary Policy In Underdevelope Countries : With Special Reference To India, p. 152.

Fourthly, no statutory limitations should be imposed on the volume and maturity of Government securities which a central bank can purchase or sell or hold. Such statutory limitations create difficulties for a central bank in effective application of its open market operations.

Lastly, the effective functioning of open market technique requires that the central bank is not committed to maintain Government security prices at any given level.

Therefore, it may be said that the extent and overall effectiveness of open market operations depend on three conditions, i.e., "the size of the resources which the Reserve Bank can muster for the purpose, the quality and volume of the assets it is permitted to deal in or hold, the capacity and organisation of the market in which they have to be carried out"[1].

It may be frankly admitted that these conditions are not fully present in India. The nature and organisation of the market from the point of view of its responsiveness to operations undertaken by the Reserve Bank are not very satisfactory. Thus the quality, volume and scope of the assets in which the Reserve Bank was entitled to operate, the narrowness of the security market and the absence of a bill

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1. S.K. Muranjan, Modern Banking In India, p. 307.

market prevented the Reserve Bank of India from using open market operations as a sensitive means of credit control either on interest rates or over the reserves of the commercial banks[1]. The organization and the capacity of the market in which the Reserve Bank has to deal are very limited. The security markets are very narrow in most of the developing countries. There are only three important security markets in India, namely, the Calcutta, Bombay and the Madras markets. The other markets are too small to be significant. Besides this, security market does not possess large number of dealers or resources of the variety of securities in India which exist in the highly organised markets of London or New York. The Indian security markets also do not possess the capacity required for the completion of large deals within a reasonable period of time. Sometimes the market is receptive when it is possible to sell and at other times the market is unreceptive. The process is exceedingly slow one. This has reduced the efficacy of open market operations in India.

The second condition of stable cash ratio is also of disappointing nature in India. Here, scheduled banks maintain cash reserves with the Reserve Bank over and above the statutory minimum which fluctuates with the changing monetary conditions in the economy. It has further reduced the

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1. G.P. Gupta, Reserve Bank of India And Monetary Management p. 147.

efficiency and effectiveness of open market operations in India.

6.5. Open Market Operations In India

The Reserve Bank of India began open market operations soon after its establishment. But, during the formative stage of the Reserve Bank of India, its open market operation were not considered to be very significant. "In the earlier years, they were on a restricted scale in the nature of seasonal open market purchases to relieve the pressure on the money market"[1]. On the whole these operations were virtually insignificant in pre-war years.

During the war and immediate post-war years, the scope of open market operations was extended and these operations functioned as an instrument of cheap money policy through 'tap-sales' of government loans. During the war-period, the main objective of open market operations of the Reserve Bank of India was to support the price of government securities in gilt-edged market to maintain confidence in the gilt-edged market and in furthering sales of government securities carrying lower rates of interest[2]. During the post-war period, the Reserve Bank undertook open market operations as

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1. K.K. Sharma, Role Of Monetary Policy In Planned Economy: With Special Reference to India, p.141.
2. G.P. Gupta, Reserve Bank of India And Monetary Management, pp. 158-9.

a weapon of debt management policy, although it had abandoned the rigid support policy and it extended discriminatory support for mitigating monetary-stringency. The Reserve Bank therefore, purchased government securities from the banking system which led to the banks to expand credit to the desired extent. Undoubtedly, the policy of Reserve Bank had the desired effect in providing the banks with adequate funds but the larger sale of government securities by the banks to the Reserve Bank and acquiring the larger funds increased the lending activities of the banks to a great extent and thereby generate inflationary pressures in the economy. In particular, there were various factors which had a continuing effe in compelling the Bank authorities to continue purchases of loans involving the monetization of the public debt, such as, a steady pent-up demand of fund for trade and industry, partition of the country and the consequent economic dislocation, a rising price level in India and abroad, accentuated by devaluation and the Korean War, a large expansion of imports which had been cut during the war, a general tendency all over the world towards credit stringency and hardening of interest rates. With the outbreak of the Korean War in June 1950, and its consequent developments in the internal and external spheres, together with an increase in speculative activity, there was a sharp increase in the demand for funds during the busy season. To meet this demand for funds, commercial banks were compelled to liquidate their holding

of Government securities. Therefore, there was an unduly large credit creation during the busy season of 1950-51.

Table : 10

Open Market Operations of the Reserve Bank of India in Central Government Securities

(Rs. in Crores)

Financial Year	Total Purchases	Total Sales	Net Purchases(-) or Sales (+)
PRE-PLAN			
1944-45	34.97	10.24	-24.73
1945-46	45.77	70.30	+24.53
1946-47	95.35	33.06	-62.29
1947-48	75.76	23.42	-52.34
1948-49	121.84	30.42	-91.42
1949-50	89.22	70.68	-18.54
1950-51	155.06	98.79	-56.27
FIRST PLAN			
1951-52	66.60	54.78	-11.82
1952-53	12.66	13.86	+ 1.20
1953-54	17.77	39.91	+22.14
1954-55	29.94	57.94	+28.00
1955-56	21.97	37.92	+15.95
Total			+55.47
Annual Average			+11.09
SECOND PLAN			
1956-57	47.47	28.30	-19.17
1957-58	24.01	89.23	+65.22
1958-59	65.10	154.05	+88.95

contd....

Table 10 contd...

1959-60	23.31	83.64	+60.33
1960-61	-	-	- 6.52
T o t a l			+ 188 .81
Annual Average			+37. 76
<u>THIRD PLAN</u>			
1961-62	-	-	- 0.81
1962-63	-	-	+10.6
1963-64	-	-	+44.7
1964-65	-	-	+98.60
1965-66	-	-	+18.80
T o t a l			+171.89
Annual Average			+34.37
<u>ANNUAL PLANS</u>			
1966-67	-	-	+62.90
1967-68	-	-	+50.40
1968-69	-	-	+96.00
T o t a l			+209.30
Annual Average			+69.77
<u>FOURTH PLAN</u>			
1969-70	315.3	345.3	+30.00
1970-71	275.7	359.8	+84.10
1971-72	258.6	309.7	+51.10
1972-73	437.0	574.7	+137.70
1973-74	358.8	414.9	+56.10
T O T A L			+359.00

Table 10 contd...

FIFTH PLAN			
1974-75	514.7	756.4	+241.70
1975-76	867.7	1373.2	+505.50
1976-77	732.2	1250.9	+518.70
1977-78	926.5	1588.7	+662.20
1978-79	903.3	1526.9	+632.60
T o t a l			+2560.70
Annual Average			+512.14

Sign - = not available

Source: Report on Currency and Finance. Various issues of corresponding years.

It was in this context that Reserve Bank had to announce simultaneously with the first upward revision of the Bank rate in November 1951, a change in its open market operations, whereby seasonal finance was provided to the banks not by outright purchases of government securities but by temporary accommodation against the collateral of government securities. It was also announced that as a normal practice, the Bank would advance money at the prevailing Bank rate on Government and other securities specified in Section 17(4)(a) of the Reserve Bank of India Act. This constituted a fundamental change in open market operations of the Reserve Bank as it 'resorted to the Bank in respect of open market operations which had lost in the post-war

years'. This was a significant development in asmuch as open market operations for the first time ceased to be primary, channel of seasonal finance from the Central Bank to the banking system and emerged as a flexible weapon of fiscal-monetary policy, which was not possible so long as net purchases by the Reserve Bank predominated. Thus from November 1951, the open market policy of the Reserve Bank entered a new and more meaningful phase of development. There was hardening of structure of interest rate and stoppage of automatic expansion of liquidity in the banking system through the Reserve Bank's purchases in the open market. The impact of withdrawl of support to gilt-edged market was a decline in security prices. The year 1951-52 saw a decline in the Reserve Bank's holding of securities in the busy season. Thus, during the year 1951-52 Reserve Bank's open market operations resulted in net purchases of Rs. 11.82 crores. It may be seen from Table 10 that the net purchases during 1946-47 to 1951-52 amounted to Rs. 292.68 crores, while as a consequence of this change, the purchases were replaced by a growing two way flow of purchases and sales with a preponderance of net sales of Rs. 67.29 crores during 1952-56. It can be seen that the phase of net purchases lasted upto 1952. The Reserve Bank's open market policy was governed by the need on one hand to avoid the creation of bank reserves by monetisation of public debt and on other hand to contribute to the stability and strength

of gilt-edged market[1]. There was no net pressure on the Reserve Bank to purchase securities unlike the previous years. Therefore, its sales operations predominated during the years 1952-53, 1953-54, 1954-55 and 1955-56. During the First Five Year Plan, the Reserve Bank's open market operations resulted in net sales of Rs. 55.47 crores with an annual average of Rs. 11.09 crores.

The open market operation policy underwent major shift in November 1956. The policy of 'no support' which continued for almost five years was modified by the Reserve Bank to one of 'discriminating support'. The qualified support of gilt-edged market was, however, designed recognising the need for credit expansion that was associated with the smooth functioning and progress of the Second Five Year Plan. In 1956-57, the Bank's total purchases amounted to Rs.47.47 crores, while the total sales stood at Rs.28.30 crores, thus resulting in net purchases for the first time since 1951-52 of Rs. 19.17 crores. This phase of purchases by the Reserve Bank of gilt-edged securities by way of support to the market was short-lived, and lasted upto June 1957. However, the Reserve Bank quickly reversed its open market policy within a year as could not improve in the market. With the raising of the Bank rate from 3½ per cent to 4 per cent on May 16, 1957, the

1. Reserve Bank of India, Report on Currency & Finance, 1952-53, p. 50.

Reserve Bank entered into a new phase of prolonged net sales of securities. It may be seen from Table 10 that net sales of securities amounted to Rs. 65.22 crores in 1957-58, Rs.88.95 crores in 1958-59 and Rs. 60.33 crores in 1959-60. Hence, the net sales of securities amounted to Rs.214.50 crores during three years, i.e., 1957-58 to 1959-60. A large portion of these sales, it may be noted, represented investment in government securities by the State Bank of funds accruing to it on account of the operation of the PL480. Sales were also facilitated by the slackness that developed in the economy because of the imposition of import restrictions that created conditions of excess liquidity and strong demand for government securities, particularly from banks. The policy of bank to indulge in large scale open market sales thus resulted in raising a sizeable amount for the government, at the same time mopping up excess reserves that could lead to abortive consequences.

In contrast to the three years of remarkable net sales during 1957-58 to 1959-60, the Reserve Bank purchased Rs. 6.52 crores worth of securities (net purchases) in 1960-61 and Rs. 0.81 crores (net purchase) in 1961-62. It was officially explained that these purchases were made to ease out the restrictive repercussions arising out of the tightening of other instruments of credit control. A large part of these purchases were the result of a change of procedure in regard to the PL480 funds which came into effect on May 12, 1960.

During the Second Five Year Plan, the Reserve Bank's open market operations resulted in net sales of Rs. 188.81 crores. During 1962-63 to 1963-64, the Reserve Bank's open market operations were directed towards absorbing the excess liquidity in the short-term money market during the slack-season. The Reserve Bank's total sales amounted to Rs.56 crores as against total purchases of Rs. 7.33 crores during preceding two years. It may be, however, be argued that the Bank was selling these securities to help the government in its deficit financing efforts. Net sales during 1964-65 increased in demand for government securities from banks in view of new liquidity requirements which came into force in September, 1964. Continuous decline in the gilt-edged market and unusual stringency in the money market during the preceding two years resulted in smaller net sales during 1965-66 amounting to only Rs.18.8 crores.

The gilt-edged market evinced a recovery during 1966-67 due to comparatively easier conditions in the money market and the interest of the commercial banks in investment was reflected in the Reserve Bank's open market operations which resulted in larger net sales of Rs. 62.9 crores. This trend became more pronounced during 1967-68 and 1968-69 by the liberalisation of the monetary policy following a cut in the Bank rate. Therefore, the open market policy of the Reserve Bank was directed towards maintaining orderly and active trading conditions in the market and aligning the yield pattern

to the general structure of interest rates. As a result, Reserve Bank's open market operations resulted in marginal net sales of Rs. 1.2 crores in 1969-70 as against as Rs.96.0 crores and Rs. 50.4 crores during the preceding two years. The phase of net sales dominated during the Third Plan period three annual plans and Fourth Plan period. During the Third Five Year Plan, Reserve Bank's open market operations resulted in net sales of Rs. 171.89 crores. During the three annual plans 1966-67 to 1968-69, the Reserve Bank's open market operations resulted in net sales of Rs. 209.30 crores. During the Fourth Plan period, Reserve Bank's open market operations resulted in net sales of Rs. 359.00 crores. This phase of net sales continued during the following years. During the Fifth Plan period, the Reserve Bank's open market operations resulted in net sales of Rs. 505.50 crores in 1975-76 which was more than twice the net sales of Rs. 241.70 crores resulted during 1974-75. During 1975-76, the open market operations resulted on a relatively larger scale which may be attributed by the comfortable resource position of banks consequent upon a record expansion in their deposit during that period[1].

According to a sectoral study of the Reserve Bank's open market operations (1948-63), commercial banks were net

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1. Reserve Bank of India, Report on Currency and Finance, 1975-76, p. 176.

sellers before the Reserve Bank changed its policy in November 1951. Thereafter, excluding transactions on account of PL480 funds, their business with the Reserve Bank has resulted in net sales in some years and net purchases in others. A noticeable feature of these transactions has been that have been usually selling securities in the busy-season and replenishing their portfolios in the slack-season. Insurance sector figured most in sales by the Reserve Bank than in the purchases, presumably for the reason that they should have made their requirements directly by taking up new issue. A sizeable volume of Reserve Bank's transactions are with Provident Funds which, however, made increasing purchases from the Reserve Bank, while there was also a sizeable category of 'residual' transactions put through brokers.

The Reserve Bank's operations also included 'switches' which involve purchases of one security against another security as distinct from outright purchase or sale of security. In other words, 'switches' instead of being outright purchases or near dated securities, were in the nature of 'swap' of one security for another with a different maturity, i.e., purchase of one loan against the sake of another and vice-versa. These 'switches' operations, generally done with the Reserve Bank's brokers, have been developed with a good deal of skill and dexterity since the fifties and stand out as a unique technique among central banks of under-developed countries. The 'switches' which are usually from short-dated to long-dated

loans enabled the average maturity of the funded debt held by the rest of economy, and thereby function as an investment of debt management. In fact, the chief objective behind the policy of 'switches' is to help to cater the shifting preference of the market and to establish and maintain a harmonious pattern of yields. 'Switch' operations were sizeable till around 1956-57 ranging from Rs.12.2 crores in 1949 to Rs. 62.2 crores in 1951 but except for a sharp rise in 1959 at Rs. 20.8 crores, they dwindled and have functioned within a range of Rs. 2.8 crores to Rs. 7.2 crores between 1960 to 1962[1]. However, the simultaneous issue of new loans of different maturities, which means greater choice of maturities to investors, may have correspondingly attenuated the need to reshuffle existing portfolios for attaining a better maturity distribution. But, the development of switch operations for regulating the maturity pattern of the funded debt holdings of major investor groups is among the most distinctive feature which have made the open market operations mainly as an ancillary tool of Government debt management and, therefore, open market operations, in India, should be viewed more as fiscal weapon than as an instrument of monetary policy.

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1. "Some Aspects of Open Market Operations Of the Reserve Bank of India", Reserve Bank of India Bulletin, December 1964, p. 1502.

2.6. The Problem Of Gilt-Edged Market

The Reserve Bank of India conducts its open market operations only in government securities. Although the Bank is authorised to re-discount commercial bills, but, as stated earlier, they have almost never figured in its balance-sheet. The Reserve Bank operates in government securities because the Bank itself is the largest single investor in the securities and substantial amounts of government securities are held by the commercial banks and other financial institutions, so that there exists a common medium of transactions, whereas market in other credit instruments is not fully developed.

The gilt-edged market is centered at Bombay, Calcutta and Madras, the policy being laid down at central office at Bombay. In these financial markets, the purchase and sale of securities is done through approved brokers. There is keen competition among these brokers and dealers who enjoy the benefit of extremely fine quotations and their business has been graviated mainly to the Reserve Bank.

The Bank has adopted the practice of buying and selling through these brokers because of the practical difficulties in dealing with the public. These dealers with their intimate knowledge of the market help the Bank to evaluate market conditions more effectively. The Bank does not publish either particulars of the various securities or the rates at

which, it decides to buy or sell. The rates for purchases and sales are determined by the Bank from time to time in the light of prevailing conditions in the market and also on the grounds of appropriateness of rates for these securities.

According to the annual survey of the Reserve Bank of India, banks continued to be an important investor in Central and State Government securities. The holding of scheduled commercial banks in Central Government securities (other than treasury bills) amounted to Rs.2663 crores at the end of March 1977 which was higher by Rs. 599 crores (or by 29 per cent) than that in March 1976. Investment in State Government securities also rose by Rs. 105 crores to Rs. 1228 crores representing an increase of 9 per cent over the year. Bank's investments in both Central and State loans as a proportion of total outstanding loans of Central and State Governments have been steadily rising. As regards investments in Central Government securities by banks, the proportion to total outstanding loans rose from 26.4 per cent in 1974 to 29.1 per cent in 1976 and further to 33.1 per cent in 1977. Similarly, banks' holdings in State Government's securities to the total outstanding State's loans rose from 46.5 per cent in 1974 to 50.3 per cent in 1975, 53.3 per cent in 1976 and 53.7 per cent in 1977. Thus banks now hold more than one-half of the State Government's loans and one-third of the Central Government loans. The

magnitude of this change and the size of the Reserve Bank's holdings point to the extent of reliance by Government on credit from the Reserve Bank.

Nevertheless, the problem of the development of gilt-edged market, concentration of Government loans by few investors and bulkiness of their transactions indicate the present complexion of the gilt-edged market. There being a smaller number of substantial investors, setting up of large business houses dealing in Government securities is not encouraged. The small number of investors remain unable or find it difficult to fulfil the large size requirements of the big holders on their own and thereby compelled to have mainly broker's services.

The problem, in India, to conduct open market operations is not, therefore, really one of shortages of ammunition in the armoury of Central bank, since the nationalised central bank acting as a fiscal agent of the Government, possesses the prerogative of creation of purchasing power. Actually, owing to the lack of well-developed Treasury bill market, the nature and size of gilt-edged market is the principal limiting factor in India[1]. Ours is a predominantly broker's market, rather then dealer's or jober's, who bear the risk of fluctuations in capital value of securities

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1. "Some Aspects Of Open Market Operations Of The Reserve Bank of India", Reserve Bank of India Bulletin, December 1964, p. 1498.

and provide a continuous market. The Indian brokers are pure intermediaries who do not assume risks and, therefore, usually fail to provide a continuous market. This important characteristic has had its impact on the size and depth of gilt-edged market and has, consequently, reduced the effectiveness of open market operations as an important instrument of monetary regulation and control in India.

6.7. Efficacy Of Open Market Operations In India

In India, the objectives of open market operations, have varied from time to time and have been conditioned by the changing economic situations and the trends in the money and capital market. Broadly speaking, in India, open market operations have not assumed the role of full-fledged instrument of credit policy. Open market operations are being used more to assist the commercial banks to tide over seasonal monetary stringency (The Reserve Bank augmented the Reserves of Banks during busy-season and to provide them with an outlet for investment during the slack-season), but they have rarely been used to restrain credit in order to control inflationary pressures in India. It may be seen from Table 10 that during 1950-51 to 1978-79, the Reserve Banks open market sales amounted to Rs. 3489.90 crores, while bank credit by scheduled commercial banks rose from Rs. 422.42 crores to Rs. 17842.00 crores during the same period.

The Reserve Bank did not engage more frequently in selling (rather than buying) securities to the banks,

constantly endeavouring to dispose of larger volume of Government securities to assist more the Government in its borrowing operations and to maintain orderly conditions in the market. The objectives of what is called 'grooming the market' which means acquiring securities nearing maturity to facilitate redemption and making available on tap a variety of loans to broaden the gilt-edged markets have been more prominent in the open market operations policy of the Reserve Bank. What is of great significance, however, is the fact that, because of limited capacity, the market failed on many occasions to absorb Government securities, with the result that the Bank had to purchase a large number of these securities itself to facilitate the deficit financing. In the words of B.K. Madan, "Open market operations, however, have tended to become increasingly a one-way traffic, with the constant concern of Government and the Bank to sell more and more Government securities to reduce the gap in budgetary operations which has to be financed in the last resort by borrowing from the Reserve Bank....Open market operations are thus becoming primarily an ancillary to Government debt management"[1]. Although, the open market operations have not been characterised as an anticyclical policy mainly due to floatations of larger loans to finance the war and to raise

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1. B.K. Madan, 'The Role Of Monetary Policy In A Developing Economy' (Chandigarh : Punjab University Publication Bureau, 1963), pp. 31-2.

the the funds for development finance during the Five Year Plans, but the need to correct inflationary and deflationary tendencies has, however, influenced the open market operations policy of the Bank throughout the period[1].

Ironically, however, open market operations in India which is supposed to be the most flexible instrument of credit control, have not always been used, with flexibility to restrain credit.

The open market policy has been used to reinforce the general monetary policy of keeping credit under control. The Reserve Bank has been able to avoid violent fluctuations in security prices. It has kept itself in touch with the market. It has also been able to fill up the gap in the supply and demand with the result that the market for Government securities has become broad. Moreover, the Reserve Bank is not to be blamed for non-use of open market operations as a most flexible instrument of credit control, since it was virtually constrained to feed the acceleration machine of deficit financing started by the fiscal authorities in the economy.

The legal and institutional setting for the conduct of open market operations is generally favourable in India. For many years now, there have been no restrictions either to the

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1. R.B.I. Bulletin, 'Open Market Operations of the Reserve Bank of India', June, 1960, p. 800.

quantity or maturity of Government securities which the Reserve Bank may acquire. The large scale borrowing undertaken to finance the development programmes under the Five Year Plans has further aided this process. The Government securities market is almost entirely an institutional market which has led to the broadening of the money and capital market in the country. It may be seen from table 11 that in recent years, there has also been decline in the cash ratio of the scheduled commercial banks in India. It has remained stable at around 6 per cent of aggregate deposits (6.8 per cent in 1970-71). Besides, the investment of scheduled banks in Government securities as percentage of their aggregate deposits, though having declined from about 32 per cent in 1960-61 to about 23 per cent in 1970-71, still constitute a significant proportion (vide Table 11). The general decrease in investment of Government securities to the extent with the decline in the cash ratio, has been advantageous indirectly and has tended to increase the efficacy of open market operations in recent years in India.

In India, it may, however, be concluded that open market operations have been used to a very limited extent as a measure of monetary management, a more important role for these operations can be attributed in the years to come in the context of rising national debt of the country and the development of securities of different maturities. In the context of controlling inflationary pressures in the economy

and the necessity to raise the finance for the Plans, the Bank's open market operations has to be, for several years to come, to find the public debt and to assist in the public absorption of Government loans to the best of its ability.

Table : 11

Cash Reserve Ratio, Investment in Government Securities and Credit Deposit Ratio of Scheduled Commercial Banks in India

(Busy-season)
(As percentage of aggregate deposits)

Year	Cash Reserve Ratio	Investment in Government Securities	Credit Deposit Ratio
1950-51	10.6	37.7	62.1
1960-61	6.7	32.0	75.6
1961-62	6.4	31.3	73.2
1962-63	6.2	29.0	77.7
1963-64	6.5	28.0	79.4
1964-65	6.3	27.8	78.7
1965-66	5.8	27.5	77.6
1966-67	6.3	26.1	78.6
1967-68	5.7	25.1	78.3
1968-69	6.3	24.3	78.7
1969-70	6.4	23.2	78.3
1970-71	6.5	23.0	79.0
1971-72	6.3	23.3	74.1
1972-73	5.6	25.0	70.5
1973-74	8.5	23.3	72.6
1974-75	6.9	22.9	72.2
1975-76	6.9	24.9	77.1
1976-77	7.8	21.5	73.3
1977-78	11.0	26.6	65.8
1978-79	12.5	23.1	65.5
1979-80	12.9	22.8	66.7

Source: Report on Currency & Finance.

The Bank may occasionally make net purchases, but only under the compulsion of maintaining a reasonable stability in the market. However, to tackle both public debt and monetary aspects of open market operations in a more flexible manner, setting up the 'Open Market Operations Committee' on American model assigning with public debt and monetary affairs with necessary changes would be, indeed, an appropriate step in India.

CHAPTER VII

VARIABLE RESERVE RATIOS

In addition to the bank rate and open market operation there is another instrument of monetary policy in the armour of central bank known as variable reserve ratios or variable reserve requirements. In view of limitations of both bank rate policy and open market operations, the central banks of developing countries have been armoured in recent years with this new and unconventional instrument of credit control in the shape of an authority to vary the minimum reserves required to be maintained by the commercial banks with the central banks. For long, the important purpose of the reserve requirements was regarded exclusively as a method of ensuring the liquidity of the commercial banks and thus of protecting depositors. It was only in the mid-thirties that these reserves came to be considered as an instrument of monetary policy as well.

7.1. Variable Reserve Ratios As A Weapon Of Credit Control

The technique of variable reserve ratios sets a limit into the expansion and contraction of credit by the banking system. According to this technique when the reserve requirements are increased, the capacity of the banking system to expand credit is restricted, as the banks will have less resources and when the reserve requirements are lowered, the

ability of the banking system to create credit is increased, as the banks have more resources. As an instrument of credit control, the variable reserve ratios are in several ways a more effective weapon than the traditional instrument of Bank rate and open market operations, though all of them best be used in coordination. Whereas, in case of open market operations the volume of reserves are affected through sales or purchases; in case of variable reserve ratios, the volume of reserves with the banks remain unchanged but by increasing the ratios the existing excess reserves can be converted into required reserves and by reducing the ratios a part of the existing reserves can be converted into excess reserves. Therefore, while the bank rate and open market operations are designed to bring about an actual quantitative change in reserve holdings and thereby in free reserves, a change in reserve ratios can immobilize the excess reserve of commercial banks by a stroke of the pen, however big these excess reserves may be[1]. In this way variable reserves ratios is really a more potent instrument which can be operated in a more flexible manner. Keynes has recommended it as a means to offset, "the possible inadequacy of ammunition interferring, in exceptional circumstances, with the efficacy of open market operations"[2]. He suggested that

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1. Alak Ghosh, '<u>Control Techniques In Indian Monetary Management</u>', p. 53.
2. J.M. Keynes, '<u>A Treatise On Money</u>', vol. II, pp.260-1 and 271.

the policy of the commercial banks in regard to commercial loans might be guided towards restriction or expansion by the appropriate variations of the minima. The adoption of this practice was recommended as 'being specially necessary in view of the underdeveloped nature of the money market'. It was also regarded as a substitute for a rising bank rate, a substitute for the process of reducing banker's deposits, through sales in the open market.

It was observed that in those countries where the facilities for open market operations by the central bank are relatively restricted, the possibility of selling securities when cash supplies seem excessive, is purely limited. In such countries, if minimum reserve ratios are thought necessary — the clearest case is to be found for flexibility in the minima[1].

Changes in reserve ratios effect at the same time and to the same extent all member banks subject to the action. The immediate incidence is upon the operating reserves and liquidity position of the affected banks. Increasing or decreasing the available reserves and liquidity of banks tends to find prompt response in the rate of bank lending and investing, in the tone of whole credit market, and in

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1. Monthly Review Of Midland Bank, London, May-June, 1937, p. 4.

the rate of monetary expansion. The fact that multiplying power of bank reserves is affected exerts either a dampening or an accelerating influence on the expansion of volume of bank credit and stock of money. Sayers also lays great emphasis on variable reserve ratios as a potent weapon of credit control. According to him, "The aggregate supply of money can be insulted from the rise in the cash basis by an appropriate rise in the legal ratios; and from a fall in the cash basis by an appropriate reduction of the legal ratios.....It is a weapon which should always be placed in the hands of a central bank whose technique is circumscribed by the conditions we are assuming....Given such powers the central bank can perform useful functions that commercial banks cannot be expected to perform"[1].

The policy of variable reserve ratios would, thus, seek to influence the commercial banks in India as elsewhere, with three objectives in view, viz., (i) to ensure the liquidity and solvency of individual banks and, therefore, of the banking system as a whole; (ii) to ensure to the Reserve Bank a supply of deposits and thus with adequate resources for its local operations; and (iii) to ensure that the Reserve Bank, using open market operations or other means should be able to influence and ultimately to restrict the commercial bank's creation of credit.

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1. R.S. Sayers, Modern Banking, 3rd edn., pp. 288-9.

But, all these objectives are inter-related since an ultimate objective of credit control is to ensure the liquidity and solvency of the banking system as a whole. However, in course of time, the first two objectives have come to be regarded as much less important than the third one in situation of rising inflationary pressures in the economy. The fact that most of the new central banks which were established during the last three decades have practised this method of monetary control, points to be widespread acceptance of the instrument of variable reserve ratios as an effective method of controlling credit.

7.2. Variable Reserve Ratios In Some Selected Countries

The technique of variable reserve ratios was first introduced in the United States of America in 1933 and extended in 1935 when the Board of Governors of the Federal Reserve System was authorised to vary the member banks' reserve requirements by regulation 'in order to prevent injurious credit expansion or contraction'. The Federal Reserve Authorities used this method not only as a means of controlling credit and inflationary conditions, but also as ensuring the supply of gold and foreign exchange and furnishing the central bank with resources. In course of time, this technique attracted a great deal of attention in several other countries where central banks experienced difficulties in controlling larger credit expansion and money market conditions. New Zealand

and Mexico in 1936, Sweden, Ecuador and Costa Rica in 1937, Venezuela in 1940 and Australia in 1941 employed this system in one form or another as a tool of monetary regulation.

Most of the many new central banks which were created during the forties, fifties and sixties, granted the legal authority to impose the method of variable reserve ratios[1]. The central banks of Thailand, Paraguay, Guatemala, Peru, Pakistan, West Germany, Ceylon, Korea, Egypt, Burma, Norway, Syria, Ghana, Argentina, Japan, Kenya, France, Chile, Uruguay, Guatemala Ireland, Dominican Republic, Italy, Philippines, Iraq, Cuba, Indonesia, Belgium, Colombia, Canada, Austria, South Africa, Netherlands, Switzerland and Great Britain have authorised to prescribe the minimum reserves to be kept by the commercial banks. Since the structure of the economy, the banking system and money and capital markets of different countries are widely different, the minimum cash reserves which the commercial banks have to maintain in the form of balances with their central banks are also at a varying range. In Ceylon, a range varying between 20 and 40 per cent was allowed against demand deposits and unused balances of over-drafts, and between 5 and 20 per cent against time and saving deposits. During inflationary periods, a reserve of 100 per cent against any increase in deposit liabilities may be

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1. For detail, see M.H. De Kock, Central Banking, pp. 223-33.

imposed, but in such an event interest has to be paid by the central bank on excess over the normal maximum reserves. But in West Germany, where this instrument has been put to frequent use, no interest is paid. In West Germany, it was provided that the minimum cash reserves which the commercial banks had to maintain with the central bank, could be varied between 8 and 20 per cent of their demand deposits and between 4 and 10 per cent of their time and savings deposits. From the beginning this instrument was used there by the central bank as a means of influencing the liquidity of the banks and reinforcing its discount rate policy.

In Korea, the Bank of Korea was empowered in its original constitution to vary the minimum reserve requirements to be kept by the commercial banks between 10 and 50 per cent of their deposit liabilities. As in case of Ceylon, the Bank of Korea was also authorised during inflationary periods, to impose a supplementary requirements of upto 100 per cent in respect of any increase in deposits after a specific date, and to prescribe different reserve ratios for different classes of bank deposits.

In South Africa, where this system was first adopted in 1956, the central bank was empowered to require the commercial banks to maintain supplementary reserves over and above the minimum credit balances which they had to keep with the central bank. Two different bases for such supplementary

reserves of upto 10 per cent of their total liabilities to the public or upto 90 per cent of any increase in such liabilities after a specific date were laid down.

In Great Britain, where the commercial banks maintained conventional reserve ratios with the central bank of upto 8 per cent of their deposit liabilities in cash and 28 per cent in liquid assets, a new arrangement with the banks was made in 1958, under which 'the Bank of England will, if need be, restrict the liquidity of the banking system by calling for special deposits', i.e., in addition to the conventional reserve ratios. These 'special deposit ratios' were raised later in various stages.

In Pakistan, ratio against time deposits was raised to the level of that for demand deposits in 1963 and, in the following year, the common ratio was raised from 5 to 7½ per cent.

In Philippines, cash reserve requirements were raised for the first time in February 1959 from 18 per cent to 21 per cent of demand deposits in three stages of one percentage point every thirty days.

In Vietnam, the reserve ratio was lowered from 20 per cent to 15 per cent in June, 1957.

In Burma, the minimum reserve requirements were raised to 6 per cent against time deposits and 16 per cent against

demand deposits, w.e.f. August 31, 1957. The additional reserves of 3 per cent against time deposits and 8 per cent against demand deposits were allowed to be kept in any category of government securities.

In China, the effective reserve requirements were raised from 13 per cent Guarantee Reserve, to 28 per cent Guarantee plus Cash Reserve in March, 1956.

In Japan, where this technique was put into force in September, 1959, it has great significance as a precautionary measure against over-expansion of the economy, and is supposed to be a remarkable step in the effective exercise of monetary control by the Bank of Japan[1].

In 1965, exclusive of United States of America, more than forty-three developed and underdeveloped countries have adopted the technique of variable reserve ratios and have put into use m more frequently either as an alternative or as supplement to the open market operations to strengthen the technique of central banking control in highly liquid conditions or even under conditions of severe credit stringi. In some countries, certain financial institutions other than commercial banks, such as cooperative banks and other long-

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1. Ryoichi Takagi, "Central Banking in Japan" in Central Banking in South And East Asia, ed. S.Gethyn Davies, p.86.

2. The Economist, 'International Banking Supplement', 1966, p. 18.

term credit banks, are also subject to cash reserve requirements. While in many countries the variable reserve ratios were employed as an instrument of quantitative credit control, it was also used in some countries as a means of selective credit control, namely, to promote the financing of agriculture or cattle-raising or productive equipment, as in Mexico, or of housing, as in Sweden, or exports of capital goods, as in various countries[1].

In United States of America, the method of variable reserve ratios has been used to supplement open market operations, the idea being to rely on open market operations for ordinary occasions and to use this instrument to meet certain fundamental disequilibrium caused by inflationary or deflationary situations in the economy.

The worldwide experiences has shown that the changes in reserve ratios form a powerful instrument for influencing the volume of bank credit and money. Changes in reserve ratios definitely affects the liquidity position and the multiple deposit expansion of commercial banks and consequently the amount available for lending or investing. In India therefore, the monetary authorities has employed this technique of monetary management to bring desired changes in the available supply of cash with a view to control inflationary pressures in the economy.

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1. M.H. De Kock, Central Banking, p. 235.

7.3. Variable Reserve Ratios In India

Under Section 42(1) of the Reserve Bank of India Act and Section 18 of the Banking Companies Act, all scheduled banks till 1956, were required to maintain a minimum cash reserve of 5 per cent of their demand liabilities and 2 per cent of their time liabilities with the Reserve Bank of India. The statutory requirements of fixed minimum reserve left by scheduled banks no doubt ensured the Reserve Bank a supply of deposits and reserves for local operations, it did not leave an effective lever in the armoury of the Bank to influence bank credit in the country. There was nothing like the regulatory mechanism to enable the Reserve Bank to expand or contract credit granted by member banks. Since the minimum was fixed by law and was not subject to variations by the Reserve Bank, the member banks could be least affected in their credit creation capacity by any policy of the central monetary authority. The scheduled banks had cash reserves for exceeding the statutory minimum with the Reserve Bank of India and the percentage of cash and balances with the Reserve Bank to total liabilities was also high. Consequently, this could not be considered as an instrument of credit control in normal sense[1].

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1. Reserve Bank of India, Banking and Monetary Statistics, 1954, p. 234.

With a view to fit in a regulatory lever in the armoury of central bank to regulate larger credit expansion in order to control inflationary pressures in India, the Reserve Bank was armed in October 1956 with the statutory authority to change reserve ratios of banks under the Reserve Bank of India (Amendment) Act, 1956. The Reserve Bank was empowered to vary the reserve requirements of scheduled banks between 5 per cent to 20 per cent in respect of demand liabilities and between 2 per cent to 8 per cent in respect of time liabilities and to require them to maintain additional reserves in respect of any increase in deposits with them after specified date and the additional reserves required to be maintained may be upto 100 per cent of such increase. The overall reserves to be maintained should not, however, exceed 20 per cent of the demand and 8 per cent of the time liabilities. These percentages are the outer limits and within them the Reserve Bank is authorised to prescribe ratios in such a manner as to immobilise the maximum amount of deposits necessary, without at the same time adversely affected such banks as have not participated in the rise in deposits. This provision would ensure equity in that the impact of any change in reserve requirements will be mainly on banks which have experienced a relatively substantive rise in deposits. The Reserve Bank could, however, at its direction, pay interest to scheduled banks on the excess of prescribed minimum requirements. In the Amendment Act, broadly speaking, three reasons

had given for maintenance of cash reserves with Reserve Bank namely to ensure the liquidity and insolvency of individual bank and, therefore, the banking system as a whole came to provide the Reserve Bank with adequate resources for its operations as a bankers' bank and to provide the Reserve Bank with an additional instrument of monetary control[1]. All these objectives are inter-related. However, in the course of time the third objective has become more important than other two objectives. Hence, the control of credit has become most important objective of variable reserve ratios[2].

7.4. Experience Of The Reserve Bank of India With Variable Reserve Ratios

The technique of variable reserve ratios remained unused till March 1960. Although, there had been sharp expansion of bank deposits after 1956, the technique of variable reserve ratios was not employed till March 1960 as the bulk of the increase in deposit resources was utilised by banks for repaying their borrowings from the Reserve Bank and also for investing in government securities which increased from Rs.347 crores in 1956-57 to Rs.613 crores in 1958-59. The aggregate deposits liabilities went up by Rs. 267 crores (to Rs. 1902

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1. Reserve Bank of India (Amendment) Act 1956, printed in <u>Reserve Bank of India Bulletin</u>, Sept. 1956, pars.(9) & (10).

2. Reserve Bank of India (Amendment) Act, 1956, par.(7).

crores) in 1959-60 as compared to a rise of Rs.184 crores in 1958-59 (to Rs.1635 crores). The bank deposits rose owing to new money created through deficit financing and increasing proceeds from PL480 transactions.

In the context of rising inflationary pressures and monetary demand in 1959-60, the Reserve Bank actually experienced with this instrument of credit control for the first time after four years in March 1960, since the power was given to the Reserve Bank in 1956. The upswing in prices in 1959-60 had occured, unlike in earlier years, in the wake of an all round increase in the production. The major factor was the high level of aggregate monetary demand which needed to be curbed. There was a somewhat unhealthy boom on the stock exchange, and the liquidity of the banking system was also substantially high. With a view of freezing the excess liquidity which would have hampered the pursuit of the tight monetary policy, the Reserve Bank used the instrument of variable reserve ratios as it was "well adapted for use in the institutional and structural framework of banking system in India"[1].

In March 1960, all scheduled banks were required to maintain with the Reserve Bank, in the form of additional deposits, 25 per cent of any addition to the demand and time

1. Reserve Bank of India, Report on Currency And Finance, 1959-60, p. 60.

liabilities after March 11, 1960, in addition to the existing (5 per cent of demand and 2 per cent of time liabilities) requirements[1]. Two important observations are, however, pertinent in this regard. First, the Reserve Bank impounded 25 per cent of the additional deposits flowing into the banking system after March 11, 1960. Second, while scheduled banks could be legally called upon to maintain reserves with the Reserve Bank upto a maximum of 20 per cent of demand and 8 per cent of time liabilities, the Bank did not make any such distinction in restoring to this measure, nor it did relate the percentage to total deposits. Instead, the Reserve Bank made the higher margin applicable at a uniform rate of all classes of deposits that would accrue after the date of order[2]. Apparently, the objective of impounding the reserve requirements was to sterlize a part of the potential liquidity of the banking system. Barely two months later on May 6, 1960 the Reserve Bank modified the reserve requirements. Under the new modification, every scheduled bank was required to maintain with the Reserve Bank additional reserves of 25 per

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1. The Notification also provided that no scheduled bank would be required to maintain with the Reserve Bank an aggregate balance exceeding 20 per cent of its demand and 8 per cent of its time liabilities, which were the upper statutory limits under Section 42(A) of the Reserve Bank of India Act.

2. This method was followed presumably to accord a fair treatment to all types of banks and also to avoid penalizing those banks that had been taken more pains to attract deposits.

cent of the amount by which its total liabilities on May 6, 1960, exceeded the level existing on the first notification date. In addition, every bank had to maintain with the Reserve Bank 50 per cent of the increase in total liabilities since May 6, 1960. As a practical compensation the Reserve Bank agreed to pay interest on the additional deposits at specific rate.

Undoubtedly, the Reserve Bank found that the impact of the changes in the reserve ratios succeeded to some extent in reducing excess liquidity of banks, excess cash balances and the build-up of government securities portfolio by banks. But the impact on bank credit was limited largely because the borrowings of banks from the Reserve Bank was much higher than in the previous few years. It may be seen from Table 12 that the statutory minimum reserves declined from Rs.69.58 crores at the end of March 1960 to Rs. 62.69 crores at the end of March 1961, and Bank's excess reserves dropped from Rs.14.13 crores to Rs.12.67 crores during the same period at the end of March 1960 to Rs. 1319.54 crores at the end of March 1961. These larger borrowings from the Reserve Bank by scheduled banks was mainly due to keeping its lending requirements unchanged, while applying this instrument. The net effect on bank credit was, thus, not appreciable. The banking system also failed to cooperate with the Reserve Bank by not falling in line with the intentions of the Central Bank, specially when such intentions were in the wider national

interest. The measure was opposed on the ground that it did not give sufficient recognition to the effect that it may have on the incentive of banks to mobilise savings in the form of deposits, for a 50 per cent addtional reserve requirements would hardly make any save banking possible.

Table : 12

Impact of Changes in Variable Reserve Requirements

Year	Cash in hand	Balance with the R.B.I.	Total cash and Balance with the RBI	Statutory Minimum	Excess
1950-51	34.95	58.36	93.31	32.05	9.85
1955-56	34.84	48.90	82.74	40.90	8.81
1960-61	45.56	71.02	116.58	62.69	12.67
1965-66	73.25	97.55	170.80	95.70	15.69
1966-67	86.84	128.77	215.62	109.79	15.66
1967-68	89.04	132.30	221.34	122.99	17.23
1968-69	108.70	166.16	274.85	138.99	20.01
1969-70	146.08	175.79	321.88	160.20	23.66
1970-71	167.22	196.74	363.96	187.54	25.21
1971-72	180.48	266.82	447.30	225.46	37.23
1972-73	220.76	266.11	486.87	275.48	33.53
1973-74	245.96	609.70	855.66	769.96	-108.93
1974-75	296.21	611.45	907.66	-	-
1975-76	308.40	607.48	915.88	-	-
1976-77	354.00	1146.00	1500.00	-	-
1977-78	469.00	1674.00	2143.00	-	-
1978-79	557.00	2634.00	3191.00	-	-
1979-80	616.00	3634.00	4250.00	-	-
1980-81	756.00	4092.00	4848.00	-	-

Source: Reserve Bank of India Bulletin, various issues of corresponding years.

Keeping in view the above, it is not surprising, therefore, that within six months the Reserve Bank had to announce relaxations, hoping that the system of penalty lending rates announced on September 21, 1960 would make the continuance of the additional reserve requirement measures unnecessary in the context of advent of busy season. The Reserve Bank, therefore, withdrew in two stages the directive issued on May 6, regarding the maintenance of the additional statutory reserves mainly with a view to operate credit regulation measures in a flexible manner.

The following measures of relaxation were, therefore, adopted:

i) Effective November 11, 1960, further impounding of increase in liabilities over the level of November 11, 1960 was suspended;

ii) 50 per cent of the reserves already impounded were released through refixing of additional reserve requirement at 25 per cent of the increase between March 11 and November 11; and

iii) The additional reserve requirement was completely revoked from January 13, 1961, and the balance of the reserves impounded released to the banks.

In India, the first experiment with regard to the use of variable reserve ratios was generally considered as complete

failure. It brought to the notice of the Reserve Bank that when additional reserve requirements were imposed, scheduled banks implemented this partly by liquidating government bonds. While this partly defeated the basic aim of higher reserve requirements, the Reserve Bank was unable to prevent this shift because of the legal limitations. In order to minimise this impact of security holdings of any future increases in reserve requirements, the Reserve Bank initiated on amendment of the Reserve Bank of India Act, 1934 and the Banking Companies Act, 1949 in September, 1962. The primary objective was to make it possible for the instrument of variable cash reserve system to work effectively by prescribing separate cash and liquidity requirements, so that higher cash requirements was not neutralised by lower non-cash liquid assets as it happened in 1960.

In India, in terms of the amended Section 42(1) of the Reserve Bank of India Act, scheduled banks were required to maintain with the Reserve Bank an average daily balance of 3 per cent of their total demand and time liabilities. This has dropped the distinction between demand and time liabilities. The Reserve Bank has been empowered to vary the reserve ratio between 3 and 15 per cent of the total liabilities. In terms of the amended section of 24 of the Banking Companies Act, Indian banks are required to maintain at the close of the business on any day a minimum amount of liquid assets (comprising till money, gold, excess over statutory reserves, balances

with the State Bank of India and with notified banks and the encumbered approved securities) equal to not less than 25 per cent of their total liabilities in India (excluding of the balances maintained with the Reserve Bank of India Act). This was to come into operation two years later, i.e., on 16th September, 1964. Thus, the overall liquidity ratio (including cash) will be 28 per cent (25 per cent and 3 per cent) of liabilities from a comparable level of 22 per cent or so earlier. The Reserve Bank has, however, been empowered to change this ratio from 28 per cent to 40 per cent.

With a view to check the rapid rise in the bank credit and to minimise the pressure on the liquidity banks, the Reserve Bank, by virtue of the power to vary the cash reserves of scheduled banks, raised the minimum liquidity ratio from 25 per cent to 26 per cent of demand and time liabilities (excluding cash) on March 4, 1970 to 27 per cent on April 27, 1970 and it was raised to 28 per cent on August 28, 1970. The statutory balances ratio, however, remain unchanged at 3 per cent. The liquidity ratio under Section 24 of the Banking Companies Act together with cash reserve requirements under Section 42 of the Reserve Bank of India Act thus reached to 31 per cent (28 per cent and 3 per cent). It was expected that this hike in the minimum liquidity ratio by three percentage points will prevent any coverage of the higher reserve requirements through the liquidation of government or other approved securities. It had, thus, further

strengthened the power of the Reserve Bank to use the method of variable reserve ratios more effectively.

In May 1973, the Reserve Bank announced credit squeeze. This was announced due to severe unabated pressure on the general price level during that period. In context of excess aggregate demand and increasingly liquidity position of scheduled banks, Reserve Bank had to adopt measures of control which could attain the twin objectives of checking credit expansion and at the same time sustaining economic growth. Therefore, the statutory minimum reserve ratios were raised from 3 per cent to 5 per cent on June 30, 1973 to mop up excess liquidity of the banking system. These variable ratios were further raised to 7 per cent in two stages on September 8 and 22, 1973. The impact of these increases in reserve requirements on banking liquidity was good enough. This impounded scheduled commercial banks reserves to the extent of Rs.476 crores. The addition of 2 per cent of statutory cash reserves was allowed to expire at the end of June 1974. The cash reserve ratios were further reduced in December 1974. This was effected in two stages. It was reduced from 5 per cent to 4.5 per cent w.e.f. December 14, 1974 and was further reduced from 4.5 per cent to 4 per cent w.e.f. December 28, 1974. These reductions provided banks with lendable resources of 120 crores. During 1974-75 and 1975-76 the price tendencies were comparatively declining. The rate of monetary expansion was 6.5 per cent during 1974-75 and 9.6 per cent during 1975-76 as compared

to a rate of 15 per cent during 1973-74. The decline in the pric e index was mainly due bumper harvest of 1975-76 and proclamation of the Emergency in June 1975 in which strict measures against smuggling, foreign exchange leakage and black marketing were taken[1]. The upward tendency in the price level were noticed from March 1976, when the monthly average of the index (new series) was 162.6 (1970-71 = 100). Thereafter the prices moved up in a steady manner, and both during slack and busy seasons. By end March 1977, the index stood at 181.5 indicating a 11.6 per cent increase over the year. These tendencies stressed the urgent need of continued fight against inflation. Therefore, the cash reserve ratios of banks which had already been increased from 4 per cent to 5 per cent w.e.f. September 4, 1976, was further increased by 1 per cent, i.e., from 5 per cent to 6 per cent w.e.f. November 13, 1976, with a view to restraining the lendable resources of banks. The hike in the cash reserve ratios to 6 per cent impounded scheduled commercial banks resources to the tune of Rs.170 crores. The upward price tendencies during the latter part of 1976-77 points clearly to the chief source of inflation as flowing from the side of aggregate monetary demand, as a result of large scale expansion in money supply. It is pertinent to note that prices were falling during the period

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1. C.N. Vakil and P.R. Brahmananda, Memorandum On Inflation Reversal and Guaranteed Price Stability (Bombay : Vora & Co. Pvt. Ltd., 1977), pp. 3-4.

September 1974 to December 1975, a period of shortfall in agricultural production a nd that prices were continuing to rise during 1976-77 during a period of aftermath of a bumper harvest in agricultural production. This indicates that it is no so much change in supply but changes in the level of monetary demand flowing from expansion in the supply of money that is responsible for variations in prices[1].

The major factors responsible for monetary expansion during the period beginning with end March 1976, were, expansion in net bank credit to the government sector, expansion in net bank credit to the commercial sector, and the increase in foreign exchange resources of the banking system. Net bank credit to the government sector had increased over the last Friday of 1976-77 by about Rs. 840 crores. Bank credit to the commercial sector had increased by about Rs. 2,750 crores. Net foreign exchange assets had increased by about Rs. 1,430 crores. The two factors responsible for monetary contraction are (i) growth in time deposits and (ii) growth in non-monetary liabilities. During the year 1976-77, growth in time-deposits was Rs. 2,393 crores and growth in non-monetary liabilities war only of the order Rs. 329 crores of which about Rs. 225 crores may be the increase in impounded deposits. Whereas, together

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1. C.N. Vakil and P.R. Brahmananda, Memorandum on Inflation Reversal and Guaranteed Price Stability (Bombay : Vora & Co. Publishers Pvt. Ltd., 1977), p. 9.

expansionary sources had contributed about Rs. 5,117 crores in 1976-77 as compared to Rs. 3,294 crores during the previous year, the contractionary factors had contributed to Rs.2,722 crores in 1976-77 as compared to Rs. 2,194 crores during the previous year when impounded deposits expanded by as much as Rs. 907 crores. During the year 1976-77 cash in hand and balances with the Reserve Bank of India showed an increase and reached to the level of Rs. 1,500 crores as compared to Rs. 915.88 crores in 1975-76. It further increased to Rs.2,187 crores in 1977-78. This was for the first time that the Reserve Bank decided to impound additional cash reserve ratio of 10 per cent of the incremental net demand and time liabilities accruing since January 14, 1977. This was employed to contain credit expansion capacity of banks within acceptable limits. This was a much more effective technique of curtailing the flow of funds than the cash reserve ratio or statutory liquidity ratio. It was observed that "The impounding of a part of the accruing deposits is eminantly suitable in the context of the growing pace of deposit accretion particularly through remittence from abroad"[1].

Though the additional 10 per cent cash reserve ratios were imposed for a period of only two months by the Reserve Bank. But it was decided to continue it further for a

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1. The Economic Times, 15 January, 1977.

longer period, as the circumstances under which it was brought in, had not changed. There had been also a sizeable growth in deposits of banks and the price trend also had not shown any sign of reversing. This additional incremental cash reserve ratio of 10 per cent was, however, discontinued from October 31, 1980.

With no abatement of the pace of monetary and credit expansion in following periods, a package of measures to help contain inflationary pressures was announced in July 1981. In May 1981, the Reserve Bank had announced the raising of the cash reserve ratios of banks from 6 per cent to 7 per cent to become effective in two phases, 6.5 per cent from July 31, 1981 and 7 per cent from September 11, 1981. The effective date of the second phase of the increase was however, advanced by three weeks to August 21, 1981[1]. The results of these increases in the cash reserve ratios are still to watch. However, this 1 percentage hike in the cash reserve ratios will provide further strength to the Reserve Bank to use the method of variable reserve ratios more effectively.

7.5. Limitations of Variable Reserve Ratios in India

The Reserve Bank's power to vary cash reserve ratios are sufficiently wide and flexible, especially because cash

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1. *Financial Express*, 12 July 1981.

reserves with the Reserve Bank will have to be maintained in addition to and not as a part of the prescribed minimum liquid reserves. The quantum of marginal reserve requirements has been left to the discretion of the Reserve Bank. It may, however, be pointed out that in comparison with other countries, the minimum statutory reserve requirements, at 7 per cent, in India is very low and probably lower than prevailing in some other low income countries like Ceylon, Cuba, Pakistan, Philippines, South Korea, etc. There is nothing objectionable in the mode of its calculation. It has been widely accepted that it is not desirable to have any differentiation between demand and time deposits for the purpose of using reserve requirements as monetary weapon.

It is also argued that although the effect of reserve ratios related to addition in deposits on assets and liabilities of banks in general, they penalise those banks more whose deposits are rising relatively fast with definitely an unintended disincentive effect on deposit mobilisation and not necessarily those whose advances are rising relatively fast. When the power is used next, possibly a scope may be found for discrimination in view of the size of the banks and, if a link is established with the rate of increase in advances for individual banks, in relation to different lines of credit. In India, the method of variable reserve ratios had depressing effect on the security market. As seen in 1960-61 experiment when the demand for bank advances was

large, raising of reserve ratios forced banks with small excess reserves to sell their holdings of government securities which resulted in a fall in the prices of gilt-edged securities. Further, the banks were not likely to have sufficient funds to invest in government securities which would have adversely affected the public debt policy.

The method of variable reserve ratios was employed as an alternative or additional means of credit control. In many countries this instrument was employed only in the form of changes in cash reserve ratios, and in some only in respect of commercial banks, and both these factors tended to limit its effectiveness as a restrictive measure. In the case of the former, an increase in the cash reserve requirements, particularly where there was not even a fixed minimum liquid asset requirement, could be partly or wholly neutralised by the commercial banks realizing some of their liquid assets through rediscount or collateral loans from the central bank or sales of government securities to the central bank in the open market, while in the latter case the restrictive effect on the commercial banks could be partly or wholly nullified by an increase in the activities of other banking or credit institutions[1]. "In fact, experience has shown that the tendency of Governments to have excessive recourse at times

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1. M.H. De Kock, Central Banking, p. 234.

to both central bank and commercial bank credit has been one of the principal factors limiting the effectiveness of variable reserve requirements"[1]

These apprehensions, however, lose their validity when the Reserve Bank, with its policy of facilitating growth with stability, uses this weapon cautiously and intellegently, with moderation, discretion and sufficient advance notice. This method has an additional advantage in the sense that it can be used selectively. Higher reserve requirements with some selective exceptions may be imposed in such a fashion that banks involved in speculative financing are severely discriminated against in comparison with those engaged in more productive activities. The desired pattern of production and investment can thus be suitably influenced to promote 'growth with stability' in the economy.

It also needs to be pointed out that the statutory liquidity ratio, as a credit control measure, does not set any rigid limit to the expansion of credit. Despite the existence of statutory liquidity ratio of 35 per cent, the scheduled banks' ratio of bank credit to aggregate deposits has risen much in recent years. This ratio has increased from 62.1 per cent in 1950-51 to 75.6 per cent in 1960-61. It has further increased to 79.0 per cent in 1970-71 and to 66.8 per cent in 1980-81. This seeming paradox is explained by the fact that in computation of aggregate liabilities

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1. M.H. De Kock, Central Banking, p. 236.

for the purpose of calculating the liquidity ratios, neither borrowings from the Reserve Bank nor borrowings from abroad are included, though such borrowings clearly go to expand bank credit. Recourse to central bank borrowing and inflow of foreign banking capital has, thus, made possible for banks to maintain higher credit ratio.

In India, however, the variable reserve ratios could not prove either as a flexible or an independent instrument in controlling bank credit expansion. In a country like India, the instrument of variable reserve ratios is actually more appropriate as a temporary expedient to meet the situation of extraordinary variation in cash reserves than for meeting the problem of seasonal variations in the demand for reserves. The statutory minimum reserve ratios at low level of 7 per cent is capable of variation in one direction only and that is only in the upward. This suggests, of course, that this instrument can be pressed into service to exert liquidity pressure, if need be, in the slack-season but its use in the busy-season, is by the same token circumscribed[1].

Despite such limitations, however, there is no doubt that variable reserve ratios have an important role to play in the execution of monetary policy to the extent that it can be made effective at particular time, either as the principal

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1. Reserve Bank of India Bulletin, "Recent Evolution of Monetary Policy in India", April 1967, p. 354.

or a subsidiary instrument[1].

Some Suggestions for Variable Reserve Ratios

The instrument of variable reserve ratios in India has thus not assumed the role of fulfledged instrument of credit policy, although this has been adopted as a part of an overall credit control policy along with other reinforcing measures. Doubts are very often expressed regarding the feasibility of the measure of variable reserve ratios as an effective method of credit control in an under-developed country like India. In fact, this method of monetary policy is generally considered blunt and clumsy. It is difficult to use the instrument of variable reserve ratios in small dose, even a small change in the rate results in a substantial change in liquidity position of commercial banks. This method is also not considered precise or exact due to uncertainity and inexactness of variation in the quantum of money.

This method of changing the cash reserves of the banking system becomes effective only in certain fixed date, a sudden and quick adjustment in the liquidity position of banks, therefore, becomes necessary. This process of adjustment in the liquidity position is likely to have adverse effect in the market. Besides, this method does not also take into account the relative strength of banks and, therefore, effects

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1. M.H. De Kock, Central Banking, p. 236.

the smaller banks more severely. There may be banks which are not in any way, affected by this technique as they have a large margin of excess reserves, while, on the other hand, there may be some banks which are affected adversely to a great extent, since they have only a small margins of excess reserves. A.F.W. Plumptre, however, observed that "the method which seeks to control the policy of banks through causing changes in their cash balances would be crude method of credit control"[1]. He, therefore, suggested, "A variable minimum ratio between all liquid assets and deposits, and not between cash and deposits as at present, would be more effective"[2]. But, it may, however, be admitted that the central bank could not ignore completely the volume of its cash reserves, "the state of cash balances must certainly be a very important item in the determination of its liquidity"[3].

Besides, the Reserve Bank of India, should take into account the extent of rise in deposits while fixing the ratios. There are two criteria as considered feasable, one is to fix a separate ratio for each bank and second is to classify the banks into groups as to capital structure, deposit liabilities or on the basis of volume of business. Groups may also be

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1. A.F.W. Plumptre, Central Banking in the British Dominions (Toronto : The University of Toronto Press, 1940) pp.270-71.

2. Ibid.,p.271.

3. S.N. Sen, Central Banking in Under-developed Money Market, p. 93.

formed, as in United States of America, on the basis of geographical regions, and reserve ratio for each group of banks may be determined separately by the Reserve Bank. If changes in reserve requirements are made applicable to groups of banks, this can meet the small or localised situations of reserve stingency or redundancy. This type of a criterion applicable to a particular groups of banks will be less liable to mis-interpretation and the changes of favouritism than when the reserve ratios are determined separately for each bank.

In the context of inflationary pressures in India, the higher reserve ratios are likely to affect definitely the credit creation capacity of banks. Experience of other countries has demonstrated that variable reserve ratios can be potent means of controlling economic fluctuations or growth of booms and slumps if these are fed by changes in the total volume of credit. In India, the banks have a large volume of surplus funds which may be lent out in the slack season to earn more profits. The policy of variable reserve ratios can prove more effective than traditional instruments of Bank rate and open market operations, though all of them can best be used in coordination. The Bank rate would be very effective in controlling an increase in the resources of banks, if such an increase results from large scale deficit financing. This is likely to put considerable independent or autonomous resources at the disposal of banks, which they could use for

further credit creation. Similarly, there are strict limits to what open market operations can achieve by way of squeezing the resources available to banks since the willingness of banks to absorb securities in certain situation is limited. By contrast, the instrument of variable reserve ratios will prove relatively quick and efficacious means of general credit regulation in the economy.

Besides, in India, the efficacy of variable reserve ratios have increased much in recent years. The growth of bank money in relation to currency in circulation has found its way into the banking sector and has increased the capacity of scheduled banks to expand credit in the form of loans, advances and overdrafts, as well as bill purchased and discounted. In India, at the end of March 1981, the total money supply with the public amounted to Rs. 23,268 crores of which deposit money (demand deposits) was Rs. 9,396 crores, while currency in circulation amounted to Rs. 13,688 crores and deposits of the scheduled banks, at the end of the same period stood at Rs.37,847 crores. The average total deposits of scheduled banks rose to Rs.6011.71 crores in 1970-71 and to Rs. 9,807 crores in 1980-81 as against Rs.880.61 crores in 1950-61. It is in this context that the method of variable reserve ratios will definitely prove of immense value to the Reserve Bank in dealing with the consequences of deficit financing by restraining the creation of uncontrolled credit by the banking system in the economy.

Further, the public debt has been rising considerably since the inception of economic planning in the country. It is likely to go up in coming years as a result of the success of loans that may be floated in the preceding Five Year Plans. The Reserve Bank will, therefore, have scope to pursue effectively open market operations along with the power to vary cash reserve ratio of the banks. When put in the operation, the system will act as a restraining factor on the activities of not only the private sector but also of the public sector in asmuch it will restrict the capacity of banks to subscribe to all state obligations. The Reserve Bank will, thus, have a positive check on the spending propensity of Government with a view to control inflationary pressures and to maintain the 'growth with stability' in the economy.

CHAPTER VIII

SELECTIVE CREDIT CONTROLS

The instruments of monetary policy discussed in earlier chapters are commonly known as general or quantitative methods of credit control as they affect the entire economy, while the regulation of credit for specific purposes or branches of economic activity is termed as selective or quantitative credit control.

General or quantitative credit control measures can only affect the cost and aggregate quantum of credit. But the problem of credit control in India, as elsewhere, is not only to regulate the total volume or the cost of credit but also to prevent its overflow in particular directions. All demands made for bank credit are not always 'legitimate' in the sense that some of them may be for socially unimportant or even harmful purposes. This undesirable use of credit becomes particularly serious when the money supply in the economy is substantially expanding and prices tend to rise because production and economic activities are lagging behind. If the bank credit is freely available, hoarding and profiteering activities are over-excited. The inflationary pressure gathers momentum and unduly high demand for credit for speculative purpose leads to excessive rise in money supply which

endangers the stability of the whole economy. Selective credit control measures may, therefore, supplement the quantitative controls in operation and thereby canalise bank credit to socially desirable and economically useful purposes.

8.1. Evolution Of Selective Credit Controls

In recent decades experiments with the instrument of selective credit controls by the central banks have become a regular feature of monetary control in both developed and developing economies.

The evolution of selective credit controls is derived from certain structural elements which limit the effectiveness of quantitative methods of credit control. "One of its main disadvantages is that it tends to affect indiscriminately all sections of the national economy insofar as they depend on credit....This defect of indiscriminate general credit control has long been realized and has often been denounced as one of the weakest spots of the orthodox monetary system...."[1]

So far, the central banks were following the traditional method of quantitative control of credit. The control of the total quantity of credit is achieved by changing the bank

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1. Paul Einzig, Monetary Policy : Ends and Means, p. 263.

rate or by open market operations or by variations of the reserve ratios of the commercial banks. Hence, the emphasis was bound to be shifted from general or quantitative credit control method to selective or qualitative method of credit control, as the method of selective credit controls selects certain desirable sectors of the economy and leaves the other sectors untouched. It is here that the sectoral control is more important than the overall control of the volume of credit.

During the Depression of the thirties, the first experiment in selective credit control measures was attempted in the United States of America. The appaling fall in prices was creating concern. For the first time, particular segments of the economy were given attention to, which was a deviation from the traditional policy of leaving the economy to free market forces. By the Securities Exchange Act of 1934, the Federal Reserve system was empowered to fix margins on credit and advanced by the banks. The instalment system was adopted by the banks to encourage the sale of consumer's goods. The Hire-purchase system also helped to revive the demand. The economy gradually showed signs of revival. This experience in the U.S.A. led the central banks of other countries to adopt selective credit control policy, in accordance with the needs of the particular situation.[1]

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1. Milima Misra, "Selective Credit Controls in India" in The Monetary Policy of the Reserve Bank of India, S.N. Sen (Rapporteur), p. 159.

During the Second World War period, a new type of selective credit control came into prominence. The Federal Reserve System was given the authority to regulate consumer credit under the Trading with the Enemies Act in August 1941. In September, 1941, the Federal Reserve Board introduced the selective credit controls in the form of the famous Regulation 'W', under which the transactions of certain companies was bound to be conformed to the Board's rule prescribing the minimum down payments and maximum maturity period over which the instalments might be spread. In the early fifties, another type of selective credit control was experimented in the U.S.A. It was real estate credit regulation.

In Australia selective credit control was used as an adjunct to the quantitative credit control measures since the Second World War.

The selective credit control measures have also been experimented in U.K. both during the Second World War period and in the post-war years[1].

During the fifties and sixties this method spread over a large part of the world.

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1. Alak Ghosh, Control Techniques in Indian Monetary Management, pp. 70-2.

8.2. Forms of Selective Credit Controls

Selective credit controls may take different forms. The main forms that these controls have assumed in India are:

i) the use of all the weapons of quantitative controls selectively.

ii) directives to increase margin requirements,

iii) regulation of the size of credit limit per borrower,

iv) requiring the maintenance of aggregate level of credit against a particular commodity at a certain level which may have a reference to the level of credit maintained in corresponding period in the past and adjustments to be made to suit the needs of the situation in a particular region[1] and

v) pre-import deposit requirements.

The selective credit controls have been used, in one form or other, both in developed and developing countries. These controls were practised by various central banks prior to Second World War, but usually by means of moral suasion and/or such technical measures as differential discount and interest rates and restriction of credit instruments eligible

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1. P.C. Malhotra and A.C. Minocha, "Working of Selective Credit Controls in India since 1956 and Relative Price Movement" in The Monetary Policy of the Reserve Bank of India, S.N. Sen (Rapporteur), p. 144.

for rediscounts on collatoral loans. The main exceptions were U.S.S.R., Germany and Italy, where not only the banking sector but the economy as a whole was controlled.

The control of consumer instalment credit which has grown out of the experience of the U.S.A., also came to be adopted by various other countries, for example, Great Britain, France, Netherlands, Belgium, Spain, Canada, Australia, New Zealand and South Africa.

Sometimes selective controls may also take the form of variable margin requirements. This method of variable margin requirements on security loans which was used as an instrument of selective credit control in U.S.A. under the Securities Exchange Act of 1934, was also adopted later in Japan.

Since the Second World War, another new method of selective control was developed in the form of a requirement that advance deposits be made by importers with the central banks, which served as a pre-requisite to obtaining import or exchange licences[1]. This new device of selective credit controls is known as pre-import deposit requirements. This form of selective credit controls was first adopted by some Latin-American and Asian countries and spread over a large part of the world during the fifties and sixties. This was experimented in

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1. M.H. De Kock, Central Banking, p. 254.

West Germany in 1950-51, in France in 1957, in Great Britain in 1968 and in Spain in 1969. This was introduced in India on June 29, 1965, but was discontinued on August 19, 1965 following a supplementary budget making changes in import duties.

8.3. Selective Credit Control As An Anti-Inflationary Weapon

Selective credit controls, unlike general credit controls, envisage to regulate the availability of money and credit in specific sectors of the economy rather than its overall availability. "While general credit controls operate on the cost and total volume of credit, selective controls relate to the distribution or direction of available credit supplies"[1]. Selective credit controls are specific significant in that they directly affect the demand for loans as well as the capacity of the banks to lend. Method of selective credit controls are thus considered to be of special significance in the armoury of central banking and have widened the scope of monetary policy in developing economies.

Selective credit controls combine in general line with quantitative control measures and thereby strengthen the monetary authorities in maintaining equilibrium in the money market as well as affect certain measures which will check

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1. Reserve Bank of India, Functions and Working, P. 57.

inflationary pressures. In a developing economy, the isolation between the capital and credit market is so great as to be 'tiresome to the conventional central banker', and, therefore, there is plenty of scope for qualitative controls in these countries, as it is on market imperfections that qualitative control depend. In such developing countries where organised and active money and capital markets do not exist, quantitative techniques of credit control are admittedly of limited significance. However, the emphasis on selective credit controls does not mean under-estimation of the importance of other quantitative measures of credit regulation, such as Bank rate, open market operations, variable reserve ratios or central bank directives. But the special features of selective credit controls are their flexibility and adoptability not usually associated with other weapons of central banking control.

In developed economies, the demand for funds may be met through capital markets and private loans and there are many substitutes for bank-credit. But in developing economies, experiencing structural changes, new sensitive spots appear from time to time and the locations of the old spots continually change[1]. Therefore, traditional tools of monetary policy are surely not enough and cannot completely fit into

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1. Alak Ghosh, Control Techniques in Indian Monetary Management, p. 68.

the changing structure of such developing economies. The necessity of squeezing the economic structure at sensitive spots has brought into prominence the selective instruments of credit control. In such economies, selective credit controls may be effective within their respective sphere without causing appreciable changes in prevailing structure of interest rates. Moreover, selective credit controls may be resorted more to overcome difficulties for a short period owing to the prevalence of active inflation than to achieve a long term objective[1]. Where there are difficulties in regard to balance of payments, as are usually bound to arise in a period of inflation and people invest their money in non-essential luxuries, selective credit controls may be useful. Many Latin-American countries have made use of this instrument with the object of reducing evil effects of inflation. Selective credit controls may also be useful where inflation is not of serious nature and where there is concentration of credit expansion in particular fields[2].

In the context of India's planned economy, the need for selective credit controls is far greater than in the advanced countries. The sensitive spots in India on which controls are needed are quite different from those of developed countries.

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1. I.G. Patel, "Selective Credit Controls in Under-developed Economies", I.M.F. Staff Papers, Vol. IV, No.1, September 1954, p. 78.
2. I.G. Patel, "Selective Credit Controls in Under-developed Economies", I.M.F. Staff Papers, Vol. IV, No.1, September, 1954, p. 78.

The impetus of the higher plan outlays increased the expansionary trends in the economy and there was a sharp rise in the demand for bank credit. Besides, in a developing economy the credit policy is faced with dilemma. In an era of inflationary pressures, some channels of investment which are socially desirable are hit hard. Further, the quantitative measures have been ineffective in implementation of monetary policy and, therefore, it is pertinent for the Reserve Bank of India to resort to selective credit controls primarily with the object of correcting distortions introduced by inflation resulting from high development expenditure. Control of credit becomes essential when dangers to inflation create diversion of resources from one sector to another. This hampers economic development in proper direction. While general credit controls may be applied here as an all-out inflationary check, selective methods are to be used to curb credit in those sectors having greatest inflationary pressure.

The technique of selective credit controls is operated in such a way that it does not affect production, movement of commodities and genuine trade operations. Moreover, the basic need is not to suppress the demand for credit entirely rather it is to discourage the credit demand for relatively less desirable purposes in favour of such forms of activity as are regarded essential to encourage the economy to grow along desired lines and also to prevent it from running off

the rails in some directions by operating controls at sensitive points in the financial system[1]. Further, in India, the basic problems are to push up both savings and investments to a higher level and to ensure that the limited investible funds are used in socially productive activities. Savings in the economy will have to be mobilised. Production rather than speculative investments require to be encouraged. In this situation, selective credit controls, if combined with a general restrictive credit policy, have a very useful part to play[2].

Selective credit controls may also be used for correcting sectoral imbalance arising out of growth process in the economy. These imbalances may be either inflationary or deflationary pressures. Selective measures of credit control reinforce factors which help in the stabilisation of prices through control over advances[3].

Selective credit controls may also be employed in remedying the lop-sideness in a developing economy. A selective fostering of loans to the existing financial institutions who do not satisfy their needs may help the economy to achieve

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1. P.C. Malhotra and A.C. Minocha, "Working of Selective Credit Controls in India since 1956 and Relative Price Movement", in _The Monetary Policy of the Reserve Bank of India_, S.N. Sen (Rapporteur), p. 143.
2. N.N. Roy, _The Role of Monetary Policy in Economic Development_, p.106.
3. N.V.R. Iengar, _Monetary Policy and Economic Growth_, p.203.

growth. The justification for selective credit controls as long-term policy is because of the desire and need for diversification of economic structure of the economy. In addition to this, selective credit controls can be effective for better distribution of the national product between different sectors of the public, between different types of industries and between various sectors of the economy.

The element of selectiveness in the controls may assume minimum margins of lending against specified securities, e.g., shares of commodities like foodgrains which might be in short-supply, and therefore, liable to speculative demands, a discriminatory high or low interest rate to be charged for some sectors of credit etc. These controls can be made both regulatory and promotional, and, one can expect flexibility, adaptability and efficacy from measures adopted by a central monetary authority, for by definition they are selective and discriminatory as between purposes.

8.4. Selective Credit Controls in Operation

In India, no provision was made in the Reserve Bank of India Act, 1934, to equip the Bank with the powers of selective credit controls. The Reserve Bank acquired the power of selective credit controls in 1949 with the passing of the Banking Companies Act. It empowered the Reserve Bank to control advances by banking companies as well as to give them directions as to the purposes for which advances might be

made. These provisions are related to Section 21 of the Banking Companies Act. The Reserve Bank was further strengthened by Section 20(3) and 36 of the same Act.

Although, the Reserve Bank has been entrusted with the power of selective credit controls since 1949, these controls were not systematised and were not a regular feature of economic planning till the First Five Year Plan. It is only after the year 1956 that the Reserve Bank has been exercising selective credit controls of the economy. Unlike some western countries where these controls have been used primarily to regulate credit against durable consumer goods and in U.S.A. against stocks and shares also, in India, selective credit controls have been operative in respect of advances against commodities of mass consumption, viz., foodgrains, sugar, oilseeds, jute and cloth, etc., and have been extended to advances against shares also.

By May 1956, the general index of prices had risen in one year by 14.6 per cent. This was mainly due to the fall in output of agricultural commodities. The substantial portion of this rising trend was brought by speculative hoarding of foodgrains using bank credit. A close observation of the bank advances showed that advances against paddy and rice increased from Rs. 11.6 crores to Rs. 24.6 crores indicating a rise of 129.3 per cent over the year upto March 1956. On May 17, 1956, the Reserve Bank, therefore, issued a directive

to scheduled banks impressing upon them the need to refrain from excessive lending against certain specified commodities and, thus, to be helpful in arresting the speculative hoarding of stocks of these commodities. In addition banks were directed not to increase any credit limits in respect of advances against security of paddy and rice or sanction any fresh credit limits in excess of Rs. 50,000 in respect of such advances. These banks were further advised to increase the existing margin of 10 per cent on these commodities. Finally, banks were also requested to make sincere efforts to reduce their aggregate advances against paddy and rice to a level not exceeding 125 per cent above that prevailing at the corresponding time of the previous year. The control was further extended on September 13, 1956 to cover bank advances against wheat, other coarse grains, grain and pulses and cotton textile including yarn.

Immediately following the directive the advances against paddy and rice declined appreciably from Rs.24.6 crores on May 11, 1956 to Rs. 4.5 crores on October 12, 1956. Impressed by this response and also to ensure smooth movement of new crops, the Reserve Bank, therefore, withdrew the restrictions on November 14, 1956. The consequences were, however, disappointing. There was almost a simultaneous increase in advances against these commodities from Rs. 5.09 crores on November 15, 1956 to Rs. 9.6 crores on December 28, 1956 and to Rs. 16.13 crores on January 25, 1957. Though there was an

increase in production of rice during the year, the prices of paddy and rice continued to rise. On the assumption that some of the advances against paddy and rice are used for speculative purposes, the Bank reimposed the restrictions with some modifications on February 9, 1957. But the scheduled bank advances did not showany remarkable decline, but still they were high and stood at Rs. 22 crores at the end of April, 1957. The Reserve Bank had, therefore, to introduce a new directive on June 7, 1957, raising the margin requirements with regard to advances against all foodgrains. As a result of this directive, the advances against paddy and rice amounted to Rs. 6.44 crores on August 30, 1957 and 12.42 crores against wheat, groundnuts, etc., during the same period.

Encouraged by the successes of this measure and to restrain a possible rise in foodgrain prices in the face of apprehensions regarding lower output in 1957-58, the Reserve Bank continued to control on advances against foodgrains during the busy-season on a slightly different basis. A directive was issued on December 11, 1957, in terms of which banks were asked to maintain each month from January, 1958, an average aggregate level of credit against paddy and rice not exceeding 75 per cent and against wheat and other food-grains at 80 per cent of the average of advances for the corresponding months of three preceding years. The directive

had a salutory effect in keeping the expansion of advances against foodgrains much below the permitted level; the advances barely exceeded Rs. 26.2 crores at the end of May 1958 as against Rs. 42.6 crores a year earlier.

With a view to correct contra-seasonal and speculative spurt in prices, beginning with March 1959, every scheduled bank was required to maintain the monthly average of aggregate level of credit against the security of ground-nuts at not more than the level of such credit in the corresponding month of 1957 or 1958, whichever was higher. On December 11, 1959, the control on advances against groundnuts was further tightened and was extended to cover all oilseeds except cotton seeds. The effectiveness of the selective directives resulted in reduction of bank advances against groundnuts from Rs.23 crores in the first fortnight of February 1959 to Rs. 17 crores in the second fortnight of March 1959. Advances against foodgrains were also brought down by Rs.20 crores at the end of April 1959. The selected credit control measures could not, however, arrest the rising tendency in the price level. The monthly average of price of foodgrains which was 102.3 in March 1958 went upto 113.8 in March 59, that of wheat from 84 to 114, that of groundnuts from 103 to 121 during the same period.

In view of the mounting inflationary pressures in the economy, the intensification of selective credit controls

continued upto the middle of 1960. During the year advances against raw jute, jute goods, shares and clean advances were brought under selective credit controls. These controls marked a vigorous application of monetary policy in India, since other monetary measures like higher reserve requirements and the stepping up of the cost of bank credit under the three tier system of Bank rate were brought into play. The compliance of banks with the selective credit controls directives continued to be generally satisfactory. Advances against paddy and rice and wheat remained well within permitted levels at Rs. 12.3 crores in March 1961. However, advances against jute were slightly higher than the permitted level. The prices of foodgrains under sub-group cereals showed a moderate fall during the year.

During the year 1960-61, there was some improvement in agricultural production and relative price stability of wholesale prices. The year, therefore, witnessed the relaxations and withdraws of various directives regarding selective credit controls particularly in respect of sugar and foodgrains. The regulatory provisions relating to advances against wheat were withdrawn completely in May 1961. The control on clean advances against loans of banks imposed in March 1960 in order to prevent possible circumvention of selective credit controls through extension of clean loans was also removed from October 23, 1961. Controls were also withdrawn from advances against

sugar, jute and jute goods. Throughout the year 1962, a number of directives were issued by the Reserve Bank of India withdrawing one by one, several of its selective controls.

On January 23, 1963, selective credit controls were enforced in respect of stock of paddy and rice against warehouse receipts. A directive was also issued on April 27, 1963, for regulating bank advances against stock of sugar by prescribing the minimum margin of 45 per cent on credit limits on advances granted to parties other than those manufacturing sugar. Further, as there was evidence of speculative withholding of stocks of groundnuts with the assistance of bank credit the minimum margin requirement to be maintained by banks in respect of advances against groundnuts was also raised from 45 per cent to 50 per cent. The ceiling limits which were allowed to lapse at the end of February 1963 were also reimposed. Keeping in view the persistent tendency of prices to rise, regulatory measures relating to advances against wheat, which were withdrawn in May 1961, were, however, reinstituted. By a directive issued on April 21, banks were required to maintain a minimum margin of 35 per cent in respect of advances against wheat.

Over the year 1963-64, minimum margin requirements on advances against foodgrains were raised from 35 per cent to 50 per cent. The average aggregate limits for advances

against 'other foodgrains' which was earlier fixed at 100 per cent of the level in corresponding period of 1962 was reduced to 90 per cent commencing from the two months period, i.e., September-October 1964. The impact of selective credit controls was, however, no doubt, successful in reducing advances against particular commodities but the economy continued to be under strong inflationary pressures. The index number of wholesale prices increased from 127.2 in 1962-63 to 139.2 in 1963-64 showing an increase of 12 points in a single year. The Reserve Bank, therefore, further directed scheduled banks, through a circular letter on January 29, 1966 to keep their advances granted on unsecured basis against all foodgrains.

During the year 1964-65 the price situation was alarming. Therefore, the Reserve Bank further tightened selective credit controls on advances against foodgrains, vegetable oils and oilseeds.

The Reserve Bank introduced the Credit Authorisation Scheme in November 1965, "....in terms of which scheduled banks are required to obtain the Reserve Bank's authorisation before sanctioning any fresh credit limit (including commercial bill discounts) of Rs. 1 crores or more to any single party or any limit that would take the total limit enjoyed by such party from the entire banking system to Rs. 1 crore or more on secured and/or unsecured basis"[1]. The main objectives behind

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1. Reserve Bank of India, Functions and Working, p. 62.

introducing this scheme were to bring the credit activities of banks in a harmonious manner with plan priorities and also to ensure an additional measure of credit regulation. The Reserve Bank has made changes in this scheme time to time according to the changing needs of the economy.

On January 3, 1966, the minimum margin requirements against paddy and rice and wheat were reduced from 50 per cent to 25 per cent. These relaxations were granted as the borrowers were dealing on government account only and there was no possibility of speculative use being made of bank finance in the trading of these commodities. In view of the considerable hoarding, the margin concession was withdrawn on August 16, 1966. As a result, the maximum margin to be maintained in respect of such advances was resorted to 50 per cent. Further, in view of the sharp increase in bank credit, especially in clean credit in 1966-67 busy-season, which took place without a commensurate addition to the physical supplies, the Reserve Bank through a circular letter on March 8, 1967 and another on March 31, 1967, urged upon banks to exercise strict control over unsecured advances, as also on advances against all domestic commodities in short supply and to keep them to the minimum level required to meet genuine needs of trade and industry in the economy. The selective credit controls largely succeeded in holding down the advances against cereals and sugar by April 1968.

In view of the large credit expansion, associated with a severe setback to productive activity during 1966-67 busy-season and persistent pressure on prices, the Reserve Bank made various changes in selective credit control measures during 1967-68. The control on advances against groundnuts and 'other oil-seeds' was tightened in July 1967 by reducing the ceiling from 90 per cent to 75 per cent of actual level in 1964-65. With the improvement in agricultural production during the busy-season of 1967-68, the Reserve Bank gradually relaxed controls on advances against paddy and rice granted to millers and wholesale dealers were exempted from credit restrictions. Similarly, in respect of advances against vegetable oils, a concessional margin of 35 per cent was prescribed for advances to the manufacturing sector, while minimum margin on trade advances continued to be 60 per cent. In respect of advances against groundnuts also, the minimum margin requirement for registered oilmills and in respect of warehouse advances was reduced from 50 per cent to 35 per cent, while the minimum margin requirements of 50 per cent of trade advances remained unchanged. During the year, on November 8, 1968, advances against gur by scheduled commercial banks and cooperative banks were brought under selective credit controls. A ceiling of 70 per cent and a minimum margin of 50 per cent was imposed.

During the year 1968-69, owing to the satisfactory situation in regard to supply and prices in respect of agricultural

commodities and against the background of a general liberal credit policy, the Reserve Bank made several relaxations in selective credit controls. In August 1968, control on advances against wheat was relaxed mainly with a view to facilitating the marketing of 1967-68 bumper wheat crops. The minimum margin for advances other than warehouse advances against wheat reduced from 50 per cent to 35 per cent. In May 1968, the Reserve Bank also relaxed its control on advances against 'other foodgrains'. In the same month, the Reserve Bank relaxed its control on advances against oilseeds and vegetable oils, cotton and kapas including vanaspati. But the banks were, however, advised to take sufficient care to ensure that these relaxations did not lead to any encouragement of speculative activities[1]. An exception to the general tone of liberalisation was the control against raw jute which was imposed on October 26, 1968, i.e., after a lapse of about seven years in view of declining production and raising prices.

In view of tight supply position and rising prices in respect of oilseeds, vegetable oils and raw cotton, the Reserve Bank of India issued a directive on January 21, 1970 tightening the control on credit against oilseeds, vegetable oils, cotton and kapas. In terms of this directive, the control on advances against foodgrains was also stiffened in order to discourage hoarding of excess stocks with the help of bank credit. The minimum margin on advances against

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1. Reserve Bank of India, Report On Currency and Finance, 1968-69, pp. 106-7.

oilseeds and vegetable oils (including vanaspati) was raised to 60 per cent and that of foodgrains to 50 per cent. With a view to reinforce the impact of these controls, the Reserve Bank also prescribed a minimum rate of 10 per cent on advances of these commodities. The Reserve Bank withdrew its control on advances against gur, sugar and raw jute due to improved supply position and considerable fall in the prices of these commodities. The Reserve Bank withdrew its control on advances against gur on January 21, 1970, against sugar on May 4, 1970 and against raw jute on September 17, 1969.

During the year 1970-71, selective credit controls continued to be employed with the objective of checking larger credit expansion for speculative and hoarding motives in order to control mounting inflationary pressures in the economy. The Reserve Bank modified its control on advances against foodgrains on December 17, 1970. Salient features of this directive were: (i) to enable commercial banks in extending direct credit to farmers against standing crops and to help in orderly marketing of such crops; (ii) to assist the banks in expanding their agricultural business in rural and semi-urban areas; and (iii) to enable banks to grant advances to foodgrains processing units such as dal mills (other than rice mills) at units with a population of 50,000 or below. The Reserve Bank also tightened its control on January 25, 1971, by raising the minimum margin from 60 per cent to 75 per cent on advances against oilseeds,

oils and vanaspati. On April 28, 1970, the Reserve Bank directed all the banks to raise the minimum rate of interest from 10 per cent to 12 per cent in respect of all borrowers against these commodities. The advances against shares were restricted by the Reserve Bank through a directive issued on August 28, 1970.

During the year 1971-72, adjustments were made in respect of bank advances against sensitive commodities in accordance with demand, supply and price situation. During this year controls on advances against raw cotton and kapas, foodgrains, oilseeds and vegetable oils (including vanaspati) were relaxed while control on advances against sugar, gur and khandsari were reimposed.

The price situation remain alarming during the year 1972-73. Crop prospects were also unfavourable. Therefore, credit controls on advances against foodgrains were considerably tightened both in respect of level of bank credit and terms of lending.

During the year 1973-74 in consonance with the restrictive general credit policy, the control over advances against sensitive commodities was also tightened. During the year, advances against cotton textiles including cotton yarn and fabrics and yarn made out of man-made fibres (including stock-in-process) were brought under the purview of this control.

In terms of the directive issued to banks on November 17, 1973, a minimum margin of 25 per cent was fixed for advances against wheat to roller flour mills which were earlier exempted from margin and ceiling controls. Advances against foodgrains to processing units, other than rice mills, at smaller places continued to be subject to the lower margin of 35 per cent in respect of stocks of raw materials (other than paddy), but the higher margin of 60 per cent was made applicable to advances against processed foodgrains.

The complete exemption which was allowed previously in respect of advances against imported oilseeds, vegetable oils and stock of imported cotton was withdrawn on November 17, 1973. The minimum margin on credit against castorseed and linseed was reduced from 75 to 60 per cent with a corresponding reduction in margin on advances against warehouse receipts covering these commodities from 65 to 50 per cent. Advances against imported cotton were also subjected to a minimum margin of 25 per cent as in the case of the indigenous new and/or long-stable varieties of cotton.

The minimum margin on advances to sugar mills was stepped up from 10 to 15 per cent in respect of stocks of levy sugar earmarked for controlled distribution by Government and from 15 to 25 per cent in respect of stocks of free market sugar.

Keeping in line with the tight credit policy, the existing selective credit control measures in respect of advances against sensitive commodities continued to operate during the year 1974-75 with certain minor modifications.

The credit policy relating to commodities subject to selective credit controls continued to remain tight during 1975-76. However, having regard to the increase in the output of agricultural commodities during the year and needs of agro-based industries, the controls were operated with some flexibility essentially through a reduction in the minimum margin requirement in respect of advances against a number of commodities.

The minimum margin on advances against paddy to rice mills was reduced from 45 per cent to 35 per cent and the margin in respect of advances against official warehouse receipts from 50 per cent to 40 per cent. The margin on all other advances against wheat to roller flour mills) was brought down from 60 per cent to 50 per cent. In the context of heavy market arrivals as a result of good harvest of oil-seeds, the margin was lowered to 45 per cent. The margin or advances against cotton was reduced from 40 per cent to 30 per cent.

In the context of the rising trend in prices of certain commodities such as cotton, gur, khandsari, oilseeds and vegetable oils during the year 1976-77, controls on advances

against them were tightened up further, essentially through increased margins. The basis for fixing the permissible level of credit in respect of advances against foodgrains, oilseeds, vegetable oils (including vanaspati) was related to 100 per cent of the peak level of advances outstanding per partly during any of the three preceding years (November-October), viz., 1975-76, 1974-75 and 1973-74 instead of the years 1974-75, 1973-74 and 1972-73. No changes were, however, made in the minimum lending rates, which varied between 14 and 15 per cent. The exemption limit in respect of advances covered by the guarantee scheme of the Credit Guarantee Corporation of India Limited, and coming within the purview of the directive on advances against foodgrains was raised to Rs. 50,000 from the existing level of Rs. 25,000 w.e.f. August 20, 1977. Minimum margins in respect of advances against oilseeds and oils were stepped up from 10 per cent to 15 per cent, against cotton and kapas from 10 per cent to 20 per cent, and against gur and khandsari from 50 per cent to 60 per cent of the value of stock for manufacturers of the commodities and from 65 per cent to 75 per cent for others.

While the general framework of selective credit controls continued to remain unchanged during 1978-79, adjustments were made in the regulations governing advances against selected commodities keeping in view the supply position and trends in prices. In the context of revival of Government control on the release of sugar stocks by mills, differential minimum

margin for advances against stocks released and those against stocks not released were reintroduced. Revised margins of 75 per cent for each credit limit was granted to parties other than those manufacturing sugar and parties manufacturing sugar in respect of stocks released for sale by Government which have left the factory or mill premises and on which excise dury has been paid. The minimum margins and interest rate against cotton and kapas, however, remain unchanged except for consequential changes related to level of stocks. Minimum margin on advances against warehouse receipts covering pulses was retained at 40 per cent for processors and raised to 50 per cent from 40 per cent for others. For regulating further expansion in commercial bank credit, the minimum interest rates under selective credit control were also raised. Sugar advances to factories which had attracted only the general minimum lending rate of 12.5 per cent, were increased to 15.5 per cent under selective credit control in respect of all stocks. Minimum lending rate for advances was raised from 14 per cent to 17 per cent for cotton textile mills.

During the year 1980-81, the principal changes made were an increase in the minimum margin in respect of advances against gur and khandsari to 65 per cent for manufacturers and 75 per cent for others in October 1980 and an increase in the minimum interest rate in keeping with the changes in other rates. In March 1981, the rate applicable for advances

to sugar mills was raised from 16.7 per cent to 19.3 per cent. The special (lower) rate applicable to cotton textile mills in respect of approved stocks was abolished. The minimum margins against stocks of wheat, paddy, rice and other foodgrains were raised by 10 percentage points across the board with exception of advances against pulses and to roller flour mills against wheat. The refinance rate in respect of both food and exports was raised from 9 per cent to 10 per cent w.e.f. July 18, 1981.

8.6. Effectiveness of Selective Credit Controls in India

The experience of selective credit controls during the period under review shows that the Reserve Bank has used the selective credit controls as complementary to the quantitative measures. Besides, the selective credit controls have been employed in order to remove sectoral imbalances in the economy. The foregoing analysis of these credit controls, however, reveals that they are aimed against foodgrains and other essential commodities. The rationale of the selective credit controls against foodgrains has been that food production is susceptible to wide fluctuations and there has always been a danger of speculative hoarding. In India, bank advances against agricultural commodities follows the seasonal trend in agricultural production. Except wheat, for which bank advances reaches its high level in October, advances against almost all other commodities reach their

peak in April so that traders can hoard and distribute the grains at profit. This is followed by a lean period of three to four months in the agricultural cycle. Besides, the continuance of rising investment expenditure financed through deficit financing coupled with the inelasticities of supply of foodgrains gave free rise to the inter-play of speculative activities in foodgrains. S.N. Sen has pinpointed that experience gained in the working of this method of control is of special significance for testing its efficacy as an instrument of monetary stabilisation.[1]

During the Second Plan period, production of rice, wheat, gram, sugarcane and groundnuts increased by 7,017; 2,237; 832; 5,066 and 950 thousand metric tones respectively, while jute production declined by 98 thousand metric tones during the same period. Due to the operation of selective credit control measures, during the Second Plan period, the bank advances declined from the level maintained in 1956. Thus, the rise in prices of rice, wheat and gram was within 25 points. The small rise in production and small decline in bank advances of groundnuts and sugarcane increased the prices by 32 and 57 points respectively, while in case of jute, the fall in production and increase in advances raised the price level by 149 points. During the Third Plan Period,

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1. S.N. Sen, Central Banking in Underdeveloped Money Markets, Third edn.,(Calcutta : Bookland Pvt. Ltd., 1961), p. 193.

production and increase in advances raised the price level by 149 points. During the Third Plan Period, production of almost all the commodities, except gram and sugarcane, rose substantially. The production of rice and wheat rose by 11,148 and 4,244 thousand metric tones respectively, while the bank advances for these commodities rose by Rs. 33.95 crores and Rs. 6.05 crores respectively. As a result, the prices of these commodities increased by 37 and 49 points respectively, which were higher by 32 and 43 points respectively as compared to Second Plan Period. Similarly, the production of groundnuts and jute increased by 3,217 and 2,115 thousand metric tones respectively and bank advances for these commodities rose by Rs. 4.92 crores and 10.33 crores respectively. This resulted in raising the prices of these commodities by 42 and 32 points respectively. It may, however, be pointed out that during the Third Plan Period, increase in production and bank advances raised the prices of all selected commodities, like rice, wheat, groundnuts, jute etc. On the other hand, decline in production and small rise in bank advances of gram raised the prices of this commodity by 98 points, while decline in production and higher rise in bank advances of sugarcane raised the prices only by 16 points during the same period.

During the period 1966-67 to 1969-70, the production of rice, wheat, sugarcane and jute rose substantially. The production of rice and wheat rose by 9,775 and 8,228 thousand

metric tones respectively. Bank advances against rice and wheat also showed continuously rising tendency thereby increased the prices of these commodities by 59 and 66 points respectively. In case of jute, the rise in production (893 metric tones) and small rise in bank advances (Rs. 4.91 crores) increased the price of this commodity by 12 points. In case of gram, decline in production (104 metric tones) and small rise in bank advances (Rs. 1.13 crores) raised the price by 72 points, while in the case of groundnuts, both decline in production and bank advances resulted in raising the price of this commodity by 58 points. In the case of sugarcane, while the production declined and bank advances increased to Rs. 55.21 crores, it resulted in raising the price of this commodity by 8 points.

In order to depict recent trends, let us examine variations in production, prices and bank advances of selected agricultural commodities during the period 1970-71 to 1979-80.

Table 13 indicates the level of production of selected commodities during the period 1970-71 to 1979-80. Variations in the Index Numbers of wholesale prices have been shown in Table 14 and the scheduled commercial banks' outstanding advances against selected commodities have been shown in Table 15. During last decade, marginal increase in production and considerable increase in bank advances raised the

prices of all selected commodities. In the case of gram, production of this commodity showed a decreasing tendency during this period.

Table : 13

Variations in Production of Selected Commodities in Recent Period

(In Million Units)

Year	Rice	Wheat	Gram	Ground-nuts	Sugar-cane	Jute (Bales)
1970-71	42.23	23.83	5.20	6.11	12.98	4.94
1971-72	43.07	26.41	5.08	6.18	11.63	5.68
1972-73	39.25	24.74	4.54	4.09	12.76	4.98
1973-74	44.05	21.78	4.10	5.93	14.43	6.22
1974-75	39.58	24.10	4.01	5.11	14.72	4.47
1975-76	48.74	28.85	5.88	6.75	14.41	4.44
1976-77	41.92	29.01	5.42	5.26	15.85	5.35
1977-78	52.67	31.75	5.41	6.09	17.96	5.38
1978-79	53.77	35.51	5.74	6.21	15.73	6.47
1979-80	42.19	31.56	3.28	5.77	13.33	6.12

Source: Economic Survey, 1980-81.

Table : 14

Variations in the Index Numbers of Wholesale Prices - Selected Commodities

	Rice	Wheat	Pulses	Ground-nuts	Sugar, Khandsa-ri & Gur	Raw Jute
Weight	5.13	3.42	2.18	1.82	7.24	0.43
1971-72	105	103	118	83	164	103
1972-73	121	110	150	131	177	120
1973-74	162	120	199	159	172	184
1974-75	189	189	196	147	189	105
1975-76	147	153	148	95	181	131
1976-77	157	159	171	173	192	143
1977-78	149	162	244	151	154	161
1978-79	158	159	240	145	162	138
1979-80	195	163	240	204	182	131

Year as on last week of.

Base : 1970-71 = 100

Source: Economic Survey, 1980-81.

Table : 15

Schedule Commercial Banks' Outstanding Advances Against Selected Commodities

(Rs. Crores)

As on last Friday of	Paddy and Rice	Wheat	All Food-grains	Sugar	Ground nuts	Cotton and Kapas	Raw Jute
March 1975	15.5	9.5	46.8	155.5	9.9	121.0	62.8
March 1976	20.1	10.6	45.9	175.6	17.2	178.1	47.8
Feb. 1977	27.0	9.7	55.4	149.3	13.1	312.9	49.1
March 1979	62.4	13.9	110.4	257.7	7.3	270.4	43.6
Oct. 1979	38.4	12.2	85.7	180.5	3.7	220.4	39.6
March 1980	73.3	10.9	121.3	211.8	9.9	239.1	41.4
Oct. 1980	55.6	12.7	106.7	64.2	2.5	209.7	35.8

Source: Economic Survey

An analysis of the variations of production, bank advances and prices of essential commodities actually shows no set pattern obeying any establishment norm or principle. It may, however, be admitted that increased production and increased bank advances have raised the prices to a much higher level. Sometimes, increase in production and small rise in bank advances kept the prices within limits while, sometimes, small increase in production and larger rise in bank advances resulted in moderate price rise. Sometime, small rise in production and small rise in bank advances raise the prices much higher. Similarly, decline in production and decline in bank advances led to a fall in prices, while decline in production and rise in bank advances raised the prices much higher. Sometime, rise in bank advances and decline in production brought down the price level.

It may, however, be stated that increased production and increased bank advances of essential commodities have aggravated the inflationary pressures in the economy. In spite of various selective credit control measures in operation since 1956, the scheduled bank advances at the end of October, 1980 against paddy and rice, wheat, sugar, groundnuts, cotton and kapas and raw jute stood highest at Rs.55.6, 12.7, 64.2, 3.5, 209.7 and 35.8 crores respectively. On the other hand, increased production of these commodities resulted in shortfall of supplies as against continued rise of

demand for them. This, in turn, has brought into freeplay of the speculative and profiteering activities with the help of rising bank credit particularly against foodgrains. Selective credit controls could not, therefore, prevent bank financed speculative hoarding of essential commodities and thereby accentuated the inflationary pressures in the economy.

All that can be said is that selective credit controls might have been of very 'marginal help' in restraining price rise of wheat, paddy and rice, gram as well as groundnuts, oilseeds and sugar. Generally, what can be expected of them is that availability of finance in so far as compliance with the central bank's directives is obtainable does not contribute to an accentuation of prices in the wrong directions. It may also be stated that whenever the decline in bank advances against particular commodities has resulted, might have been due to other factors like reduction in demand for bank credit at the time of slack-season and also due to an increase of production of these commodities. In fact, selective credit controls cannot alter the course of strong price movements arising from causes other than availability of bank credit.

Prices, in fact, are mainly a function of demand and supply and in the context of prevailing shortage of foodgrains, credit control can hardly be expected to avert a rise in prices. The hoarding power of the agricultural

producers has also increased and there is evidence of producers holding off from the market, as revealed by field enquiries conducted by the Bank. The extent of financing done by banking system for foodgrains in India is very low but in the case of cash crops like oilseeds and commodities like sugar, bank finance accounts for a substantial part of the total financing and the restriction in bank lending in this sphere can produce significance results. On the whole, it may be said that, in India, selective credit controls have at least succeeded in moderating price rise where the fluctuations in the output of primary commodities are considerable, leading to speculative variations in prices.

8.6. Limitations of Selective Credit Controls in India

It may, however, be stated that selective credit controls have not been successful in controlling inflationary pressures in the economy. The relative ineffectiveness of the selective credit controls in India arises from a number of limitations.

The structure of money market in India itself limits the effective operations of selective credit controls. Any selective directive to scheduled shifts the credit to non-scheduled banks and the indigenous banks. These controls do not take into account a host of these non-scheduled banks and the whole indigenous sector of the money market. This has caused the determined borrower to go outside the banking sources, often paying a high rate of interest but still

obtaining the funds. The existence of the unaccounted sector in the economy greatly facilitates such transactions and thus actively comes into conflict with the selective credit controls. The efficacy of selective credit controls has also been weakened by the lending operations of cooperative institutions insofar as these institutions have been outside of the purview of these regulations.

The effectiveness of selective credit controls also depends upon the active cooperation among banks, the business community and the Reserve Bank of India. The former Governor of the Reserve Bank of India observed, "The operation of the selective credit controls in India has thrown up a new problem of varying its incidence regionally, apart from its incidence on the volume of credit for the country as a whole. It has been found that if selective credit controls is to succeed, some control over the total credit that could be made available by the banking system is inescapable"[1].

Besides, the problem of enforcement of selective credit controls among a host of banks differing widely in the structure of assets and liabilities and some of them possessing large net work of branches scattered throughout the country, has bristled with some difficulties. The Governor of the Reserve Bank of India has admitted this fact, "The administration of the selective credit controls has not, in practice,

1. Statement of the 13th General Meeting of the International Monetary Fund.

proved on easy task. In practice, there are limitations to the ability of banks to exercise detailed controls over scores of branches located in widely separated parts of the country with divergent economic conditions and credit needs[1].

There is also considerable time lag between the introduction and the implementation of directives issued by the Reserve Bank of India. At least two months are taken before the Reserve Bank's directives would be given effect.

The withdrawl of a line of credit even at some notice, inevitably impose a certain degree of hardship. But added to the resistence from the constituents, there has been certain looseness in the effectiveness of managerial control over a sprawling net work of branches. At times, time is being passed away in getting clarification from one authority to another.

There is also a scope for evasion by overvaluation of stock kept in godowns to oblige the customers. Moreover, there are no restrictions on clean credit as a result of which higher margin requirements can be adjusted through a clean loan[2]. The efficacy of selective credit controls is limited due to the difficulties of securing compliance by banks when

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1. Statement of the 19th General Meeting of the International Monetary Fund.

2. Ibid.

control is imposed after excessive lending had already taken place, or the difficulties of adapting the control to the future pattern of production, that is to say, of imparting requisite flexibility in relation to changing credit demands in a system of control which is primarily resulted with reference to a base period or of curbing accumulation of inventories through alternative sources of finance, so long as the initiating course of speculative wave, viz., scarcity of supplies in relation to demand persists[1].

Selective credit controls can regulate the bank credit for the commodities concerned but they are less effective in an atmosphere of overall monetary expansion which makes it possible for operations to get funds from the non-bank sources. This implies that monetary and fiscal policy should be coordinated, so that both can be effectively implemented in furtherance of economic goals. The impact of fiscal operations in the overall monetary expansion has to be borne in mind especially in aperiod of large outlays of defence and development[2].

Again, there are difficulties on the reliable amount and quality of statistical information regarding out-turn of

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1. R.K. Madan, The Role of Monetary Policy in a Developing Economy, p. 30.
2. Report of the Central Board of Directors of the Reserve Bank of India for the year ended on June 30, 1964, p.8.

crops and the supplies coming in the markets. This results into hoarding or transferring of commodities by the traders from an area of plenty to an area of scarcity in order to yield a higher return, assisted by bank credit. However, the innumerable limitations are set in before the authorities introduce credit policy. "Improvements in the present situation in regard to the availability, coverage and accuracy of such information should help to enhance the effectiveness of such a policy"[1].

It may, however, be stated that in India, the effect of selective credit control measures had been of no avail in controlling inflationary tendencies of prices. Under Indian conditions, where the fluctuations in the output of primary commodities are rather excessive leading to considerable variation of prices, selective controls could score only limited success. Therefore, it was almost impossible for such controls to stem the price-rise[2]. The foregoing analysis showed that the part played by these measures in India is a negative role in the sense that the method is applied only with the objective of restraining bank advances to particular sectors of the economy rather than for promotion of business activity as it has been done in some countries of the West.

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1. Report of the Central Board of Directors of the Reserve Bank of India for the year ended on June 30, 1964, p.8.

2. Alak Ghosh, Control Techniques in Indian Monetary Management, p. 81.

The effect of these measures along with other quantitative measures has been insignificant. In fact, the effectiveness of selective credit control measures lies in cumulative efforts of quantitative and qualitative measures covering the large number of sectors and promoting other business activities in the economy.

Selective credit controls are negative in their approach and doubtful in their impact. The survey of selective measures indicates that these measures have rather negative or where they had some effect it has been just marginal. It is rather more difficult to ensure the end use of credit flows so that only productive and durable forms of investments are encouraged. It has been observed that success which they have attained, have been associated with means of general credit controls employed in combination with selective controls, rather than ascribable to themselves[1]. As such, these controls in India have only a supplementary and not a substitute role. In foreign countries also, the general experience has been that selective credit controls are effective only when they are operated in the framework of overall credit restrictions.

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1. B.K. Madan, The Role of Monetary Policy in a Developing Economy, p. 80.

CHAPTER IX

MORAL SUASION

In addition to the above mentioned instruments of monetary policy, i.e., Bank rate, open market operations, variable reserve requirements and selective credit controls, moral suasion has also been applied in India as a method of credit control.

9.1. Meaning and Scope of Moral Suasion

Moral suasion refers to those cases where the central bank attempts to achieve its objectives by appealing the banks to carry out their duties and responsibilities by voluntary agreement with them, and, where detailed directions where issued in the form of requests and guidelines rather than as legal directives[1]. Through moral suasion, the central bank gets the willing cooperation of the banking system, without which "it may not be possible for the central bank to achieve tangible results in the long run in the direction of qualitative credit control"[2].

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1. M.H. De Kock, Central Banking, p. 256.
2. K.K. Sharma, Role of Monetary Policy in Planned Economy: With Special Reference to India, p. 163.

The method of "moral suasion has at least the advantage of creating a less unfavourable psychological reaction than in the case of obvious compulsion associated with legal directives, and that it has found more conductive to securing the willing and active cooperation of the banking institutions directly concerned, in the spirit as well as the letter; and ....moral suasion can also be used over a wider area than the banking sector, i.e., beyond the area usually covered by the central bank's legal powers"[1]. Therefore, the technique of moral suasion can often exert a considerable influence. The Reserve Bank also assumed that "moral suasion, backed as it is by the Bank's vast powers of direct regulation, has proved quite useful"[2].

But it should also be noted that while the central banks have wide scope for the use of moral suasion as an instrument of monetary policy, its limitations must be recognised. Mere possession and application of the moral suasion is not sufficient in achieving the desired object. Success of moral suasion totally depends upon the degree of cooperation between the central bank and the commercial banks and other banking and financial institutions. Central banks need the wholeheartec and continuous cooperation of them for the effective use of moral suasion.

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1. M.H. De Kock, Central Banking, pp. 256-7.
2. Reserve Bank of India, Functions and Working, p. 63.

The technique of moral suasion may not be very successful while working as an independent tool amidst the other tools of monetary policy. When the central bank requests to the commercial bank to follow a particular lending policy, the lending policy of the banks may not be always influenced by such appeals and, therefore, "....such requests would sooner or later have to be underpinned by statutory powers"[1]. This is why the moral suasion is regarded as a supplement to, but not as an alternative to, more direct policy decisions[2].

9.2. The Reserve Bank of India and Moral Suasion

The Reserve Bank of India has not put heavy reliance on moral suasion as a method of credit control. Though it has wide powers of control, supervision, inspection and intervention both under the Reserve Bank of India Act 1934 and the Banking Companies Act, 1949. This does not mean, however, that this instrument is totally discarded. In the context of controlling undue credit inflation in the economy, on several occasions, the scheduled commercial banks were warned and were requested or advised to follow a line of restraints.

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1. R.S. Sayers, Modern Banking, pp. 127-8.
2. K.K. Sharma, Role of Monetary Policy in Planned Economy : with Special Reference to India, p. 165.

In September 1949, following the devaluation of the rupee, the Governor of the Reserve Bank of India held a meeting of the leading bankers of the country at which they were requested to cooperate with the authorities by refraining from making advances for speculative purposes. In June 1957, a letter was addressed by the then Governor of the Reserve Bank of India to the bankers in which it was pointed out that there has been a substantial increase in bank credit and asked them to be careful in their lending activities in order to control the general inflationary tendencies and to bring down the quantum of their lending and reduce their deposits-advances ratio to lower levels, and this had to be achieved without diminishing the assistance provided by the banking system to the essential sectors of the economy and especially, without adversely affecting the rising tendency in industrial production. Further, in July and August 1958, the Reserve Bank asked the scheduled banks to abstain from extending finance against blocks of shares to parties speculatively inclined. Later on, in November 1958, perhaps sensing that finance provided by banks might have been excessive, the Reserve Bank called upon scheduled banks to furnish particulars of such transactions since March 1958. On December 1959, the Reserve Bank requested the scheduled banks to take steps to discourage the practice of rediscounting clean hundies by parties affected by the Bank's selective credit control directives. Subsequently, on March 11, 1960, the Reserve Bank prevented scheduled banks through

its statutory powers from financing directly of such transactions.

It may, however, be stated that the instrument of moral suasion in India was employed mainly in the form of requests made by the Governor of the Reserve Bank to scheduled banks. It has, generally, been used before the commencement of the slack-season for reducing excessive credit expansion in the economy. The request made by the Governor in a conference of leading bankers in August 1957, succeeded in achieving a reduction in total bank-credit, which fell to Rs. 847 crores by end-September from the peak level of Rs. 938 crores at the beginning of June 1957. Similarly, the request made for 1959 slack-season was for reduction of the banks' advances by not less than Rs. 100 crores, which may be said to have been more or less complied. But, the request made in 1960 slack-season could not bring down the total level of advances to the desired extent. The total bank credit in the slack-season amounted to only Rs. 20 crores requested for. During the slack-season of 1965, the reduction in the scheduled bank's credit was about half of that suggested by Bank's Governor, i.e., Rs. 200 crores. In view of the unduly high expansion in bank credit on March 31, 1967, the Reserve Bank warned scheduled banks that continuous excess borrowing from over one week would attract deterent penal rates and the Reserve Bank would take serious view of non-compliance by banks of its directive regarding allocation

of a minimum of 60 per cent of additional credit to the industrial sectors and import-export bills. This sharp reminder to the banks produced an equally sharp reaction amongst them. The total bank credit stood at Rs. 101.81 crores against Rs. 426.14 crores in the busy-season of 1966-67. During the 1971 slack season, banks were advised, in the context of an increase in their liquid resources, following a sharp increase in deposits and slower growth in credit, to conserve their resources for deployment in the following busy-season, by repayment of borrowing from the Reserve Bank and/or by stepping up investment in Government and other approved securities. At the same time, it was impressed upon the banks that the credit needs of priority sectors, urgent working capital requirements of industry and the seasonal credit needs of jute and tea industries should be given the fullest possible attention. The overall economic situation during 1971-72 warranted a cautious approach. In particular, it was stressed by the Governor in a circular letter dated November 15, 1971 that banks should view their borrowings from the Reserve Bank during the busy-season as a step only to meet their inescapable needs of finance for short periods. It was suggested to the banks that their borrowings at the end of the busy season should not exceed those as at the end of the 1970-71 busy-season (Rs.191 crores). Following this appeal banks' borrowings from the Reserve Bank considerably dropped during next year.

9.3. Significance of Moral Suasion in India

In India, the technique of moral suasion has not been resorted to any significant extent. The use of this instrument has been limited to the creation of more congenial and cooperative atmosphere among the bankers so that other central measures could be effectively imposed in a friendly manner. In fact, methods of more positive character or nature have been used frequently. Actually, the banking structure in India is hardly suitable for this purpose. There are big commercial banks usually having large cash reserves at their disposal as to be always independent of the Reserve Bank's control. Moreover, a significant part of the money market is un-organised and lies out of the sphere of action of the Reserve Bank[1]. In fact, the success of this measure depends to a great extent on the prestige and personal authority of the central bank of the country, the technical means and statutory powers at its disposal and the degree of cooperation between it and other banks and financial institutions, and the make-up of the country's banking and credit structure. The Reserve Bank might, however, have brought the desired influence on the general credit situation through the informal suggestions to the banks and that such suggestions might have proved more important than any other formal statutory action,

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1. This has been discussed in detail in Chapter III.

but moral suasion as an effective instrument of monetary policy can not be said to be practicable in Indian conditions. Clark's observation is quite applicable to Indian situation. "The efficacy of warnings as an instrument of credit control have been very slight", for "while at time they no doubt have exerted a restraining influence, the forces making for explanation have proved too powerful for warning and requests without any teeth in them to be effective"[1]. Moreover, in recent years, owing to the nationalisation of banking system, the Reserve Bank has acquired wide powers of effective control, moral suasion, in India, has lost much of its significance as an instrument of monetary regulation. Hence, "the impact of moral suasion is more difficult to assess as an independent credit instrument than others"[2]. Still, its significance could not be denied in exerting an appropriate influence on non-scheduled banks and also on other credit and financial institutions generally considered outside the scope of Reserve Bank's control in India.

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1. Colin Clark, Central Banking Under the Federal Reserve System, pp. 262-71.

2. Sailesh Kumar Bose, "Monetary Policy of the Reserve Bank of India - Review of a Decade Under Planning", in The Monetary Policy of the Reserve Bank of India, S.N. Sen (Rapporteur), p. 43.

CHAPTER X

CONCLUSIONS

10.1. Summary and Findings

The monetary policy remained almost passive upto 1951. The year 1951 marked as a milestone by launching of the First Five Year Plan in India. From 1951 onwards the monetary and credit policy of the Reserve Bank of India came into active use.

During the last thirty years of planning in India, aggregate monetary demand which accentuated the inflationary pressure in the economy, was facilitated by a sharp expansion of monetary resources. Of the increase in monetary expansion, money supply was certainly an important factor. During the period under review, bank credit to the private as well as to the public sector rose substantially but this outpaced the growth of the real national income, which aggravated the inflationary pressures in India. A greater part of the money supply in the Indian economy consists of currency whose supply is determined by the monetary authorities[1]. It

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1. Kamta Prasad, Role of Money Supply in a Developing Economy: A Theoretical And Empirical Analysis (Bombay : Allied Publishers Pvt. Ltd., 1969), p. 134.

has been suggested that a 30 per cent cut in money supply in the country must be executed to withdraw excess money from general circulation and to bring about a substantial drop in the price level.[1] It is in this context that the role of the monetary policy of the Reserve Bank of India has to be evaluated with a view to reduce the pressure of monetary demand without at the same time impairing the object of 'growth with stability'.

In order to control inflationary pressures, the Reserve Bank has been fully conscious of the importance of the role it has to play and has used all weapons of credit control in its possession, both qualitative as well as quantitative. Through the use of various credit control measures, during the period under review, it has sought to regulate (i) the cost of credit, (ii) the quantity of credit, and (iii) the purpose of the use of credit.

As regards the cost and the quantity of credit, the Bank rate policy deserves special attention. During thirty years of planning period, the Reserve Bank made nine upward revisions, from 3 per cent to 10 per cent in the Bank rate. Every time the Bank rate proved ineffective as an instrument of affecting the cost of credit and to control inflationary

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1. C.N. Vakil, et.al., Memorandum to on a Policy to Contain Inflation (Bombay : Dr. D.T. Lakdawala, 1974), p. 16.

pressures. The Reserve Bank instead of raising the Bank rate in a more straight and forward manner, introduced systems of penal rates and net-liquidity ratio keeping the basic Bank rate moderately high thereby formalising the rise in the structure of interest rates through the back door by increasing the Bank rate. The cut in the Bank rate by a full point in March 1968 was undesirable and untimely and it was a clear indication of the slackening grip of monetary control on the organised banking sector and yielding of the Government and the Reserve Bank to the pressures of private enterprise. The present rise in the Bank rate on July 11, 1981 was also not considerable effective in checking the bank credit expansion and consequent increase in money supply.

The ineffectiveness of Bank rate as an instrument of credit control could have been taken as a foregone conclusion due to the volume of large cash reserves and maintenance of higher liquidity of the scheduled banks on the one hand, and the higher expansion of bank credit on the other. The Reserve Bank was, therefore, in no position to impose discipline on the scheduled banks through changes in the Bank rate at which it was prepared to grant them loans. In fact, the Reserve Bank has been reluctant to make more frequent use of the instrument of Bank rate due to the imaginery fear that higher Bank rate would increase the cost of Government borrowing. In the context of inflationary pressures, the higher Bank rate could be more effective as a positive incentive to save

and curtail consumption and it will also not affect this investment adversely if psychologically an atmosphere of growth is kept up. The noted economist Prof. P.R. Brahmananda has also suggested increasing the Bank rate to 15 per cent to combat present explosive inflationary situation[1].

An unique feature of open market operations of the Reserve Bank of India has been to augment the reserves of commercial banks in times of monetary stringency particularly during the busy-season and to provide them an outlet for investment during the slack-season. Ironically, however, open market operations, the most flexible instrument of credit control have not always been used with flexibility to restrain credit with a view to control inflationary pressures in India. The Reserve Bank has often been engaged in selling (rather than buying) securities to the banks, constantly endeavouring to dispose of larger volume of government securities in order to bridge the budgetary gap that has been created by the Government's deliberate use of deficit financing. What is of great significance, however, is the fact that, because of limited capacity, the market failed on many occasions to absorve government securities, with the result that the Reserve Bank had to purchase a large number of these securities itself to facilitate deficit financing. In practice,

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1. Northern Indian Patrika, 30 May, 1980, p. 1.

therefore, open market operations became primarily an ancillary method to Government's debt management and these operations have lost much of their significance as an effective instrument of controlling credit in India.

However, the general decline in investment of government securities to the extent of the decline in the cash reserve ratio of scheduled banks in recent years has tended to increase the efficiency of open market operations in India. It may be hoped that with the gradual dimmunition of the seasonal character of the money market, it would be possible to spread Government borrowing operations over a long period thereby tackling both public debt and monetary aspects of open market operations in a more flexible manner. In fact, open market operations have been employed as a monetary instrument only to a very limited extent[1]. Setting up of an Open Market Operations Committee assigning both public debt and monetary affairs would indeed be an appropriate step in India.

As regards Bill Market Scheme, it achieved limited success in controlling credit expansion by the banking system in India. The mechanism of 'cash credit' and 'overdraft' by scheduled commercial banks remained the more flexible and convenient form of borrowing and the growth of an active bill

1. H.V.R. Iengar, Monetary Policy and Economic Growth, p.200.

market was, therefore, not likely to be reproduced on a significant scale. Nevertheless, the introduction of Bill Rediscounting Scheme has imparted flexibility in the money market because it seeks to develop a well-organised money market, provides greater liquidity to the credit system and introduces diversification in the type of instruments for financing industry and trade in the economy.

The instrument of variable reserve requirements succeeded to some extent in reducing the excess liquidity, excess cash balances and the build-up of government securities portfolio of banks. But its impact on restraining credit was rather limited. Despite the existence of liquidity ratio of 36 per cent, the liquidity ratio as credit control measure could not set any rigid limits to the expansion of credit. The credit deposit ratio has remained around 70 per cent in recent years. As an experiment, the use of this instrument was, however, useful in the sense that it pin-pointed the fundamental principle of monetary policy that the various instruments have essentially to be coordinated and employed in combination, if they are to be effective. In a developing economy, where the aim of the monetary policy is to facilitate 'growth with stability', the instrument may be used in a more flexible and independent manner to control the expanding credit. In India, however, this instrument may be more appropriate as a temporary expedient to meet the situation

of extra-ordinary variations in cash reserves than for meeting the problems of seasonal variations in the demand for money. A selective use of this tool can definitely curb the activities of banks involved in speculative financing and encourage those engaged in more productive activities and thus, it can help in controlling inflationary pressure in the economy.

An analysis of selective credit controls has revealed that although selective credit controls were used very extensively, their effectiveness in general was comparatively limited. These controls proved inequitable in incidence, inefficient to countervail inflationary pressure and to restrain increase in prices of essential commodities, discriminating against certain commodities, individuals and groups and involved the monetary authority in the allocation of credit when its legitimate function was mainly to control the total available supply of credit. The part played by these controls was also negative one in the sense that they have been used almost entirely as a weapon of restraint while they could also be used for the promotion of the business activity in the economy. In India, selective credit control could also not get the desired success owing to various structural and administrative factors operating in the economy. The effectiveness of these controls, however, lies in cumulative effort of qualitative and quantitative measures covering the large number of sectors in the economy.

The experience of the working of selective credit controls have revealed that when they operated in isolation of the quantitative credit controls, by and large their effect was limited, since in the absence of several other credit curbs, there could have been at times, an inflow of credit from other sources of credit to the controlled sectors. Besides, sometimes these directives have been introduced either too late or withdrawn too early. Moreover, time lag has also to be reduced between introduction and implementation of directives issued by the Reserve Bank of India. The Reserve Bank has often used persuasive methods exhorting the scheduled banks to restrain their advances to a particular sector, rather than using formal directives. Selectivity has also to be adhered to in order to make the monetary policy dynamic and push up the economy out of the hurdles.

In final analysis, it may be stated that in order to control inflationary pressure, during the planning period in India, the keynote of the monetary policy of the Reserve Bank has been to maintain both general and a selective restraint on credit and pruning down of less essential demands through the combined use almost of all the monetary weapons quantitative and qualitative in varying degrees and frequency. In other words, there was a very careful and continuous planning on the part of the Reserve Bank to play the 'development' role over and above the 'regulatory' role. But, in

actual practice, the results which were achieved under the circumstances, were not considered satisfactory. There has been a more or less continuous rise in the general level of prices, induced by monetary forces, i.e., excess of monetary demand, which has accentuated inflationary pressure in the economy. The Reserve Bank's credit restrictions have always fallen short of the extent of the restraint which the authorities hoped to achieve or some of their critics feared might be brought about. It is only as earlier steps had failed to meet the situation adequately that the subsequent tougher steps had been taken. In fact, the Reserve Bank has adopted a hopping and hesitant attitude in the field of monetary control. What is particularly gratifying to note is the desire on the part of the monetary authorities to experiment and innovate. But if judged by achievements, the effectiveness of those 'experiments' has been very limited. The accentuation of inflationary pressure is basically an outcome of the widening gap between aggregate demand and aggregate supply and credit restriction by itself cannot be expected to control the inflationary pressure in India. Monetary policy is important to control inflation but in fact, it had virtually no control and it is not sufficient enough as it operates on the demand side. At best, it can contribute to some extent to the narrowing of the balance between aggregate demand and aggregate supply.

In India, where the monetary authorities are called upon to extend the credit to the Government due to high level of investment expenditure, which in turn, led to the larger monetary expansion, the measures taken to curb the private sector will not suffice to control the inflationary pressure. In fact, control of monetary expansion is not wholly or even largely under the control of monetary policy. Monetary policy in India has come into abrupt collusion with the very objective of expanded fiscal policy to achieve a high level of investment. In this way, whatever may be the types of monetary policy chosen and however sufficient is the way in which the policy is administered, it can, at best, hope to have a limited success in the overall objective of the attainment of 'growth with stability'.

10.2. Appropriate Lines of Direction

Control of inflation is not a function of one or two variables. Inflation in India is basically an outcome of various factors operating on the side of demand as well as supply. Monetary policy alone, however, essential to control inflationary pressures, will not suffice to maintain 'growth with stability'. Inflationary price rise is really a complex problem and can be tackled only through the formulation and execution of a suitable anti-inflationary policy aiming to attack all fronts of demand and supply conditions simultaneously.

The role of money and other financial assets is crucial in determining the speed of economic development in view of the monetary manifestation of the growth process. Any increase in the money supply at a rate faster than that required by the rate of growth in national income, the liquidity function and the pace of mobilisation plus the demand for the bank credit required by planned investment projects is very likely to increase the aggregate monetary demand. Monetary policy can make Government's planning policy more effective through suitable application of monetary instruments. For securing appropriate change in monetary demand in the desired directions, the monetary authorities have to decide what level of general monetary demand is desirable in a given situation. The change of demand in the desired directions can only be secured if the authorities can secure as large as impact as possible on both the availability of money and general state of confidence and expectations. The proper role of monetary policy is to ensure an adequate and steady flow of money to those sectors of the economy which deserve it according to the criteria of the objectives of the plans.

Till now and even after the nationalisation of major banks, banks' advances have not been properly integrated into the structure of planning. Nationalised use of banks should in particular, be assigned a positive role to the

consideration of planned priorities in granting bank advances. Qualitative credit controls shall have to be implemented in a manner so as to induce private sector investment to follow the priorities laid down in the Plan, encourage economy and discourage hoardings. General credit policy shall have to be determined in such a way that the power of Reserve Bank to vary the rates of interest charged by banks on different types of advances could be utilized to ensure that the bank advances go in the desired directions. A positive control will, thus, be imparted to credit control and at the same time, scope for inter-play of market forces though restricted, will still be retained. The scheme of differential interest rates which was announced on March 26, 1972 was a wise step towards achieving the goals sought by the nationalised banks in the economy. The scheme was mainly meant for lending to poor borrowers at a concessional rates for productive endeavours. The success of the scheme, however, depends on the ingenuity, imagination and resources of the banks which would make the differential interest rate policy an effective instrument of the distribution and the use of credit for furtherance of the economic and social objective set by the nationalisation of commercial banks in the economy. The nationalisation of banks could check the tax evasion and spot out black money. The banks, if they are meant to play their proper role in developing economy, have to be moulded into the same pattern in which the economy plans to mould

itself. Without that they tend to act at cross-purposes with national Plans and help factors and elements opposed to these Plans. The success of nationalisation of banks will depend upon the morale of the executives, employees and the public and this in turn, will depend upon policy decisions in respect of the most intricate economic problems of our country. A well-thought out monetary policy may, therefore, have to be applied for facilitating the attainment of 'growth with stability' in India.

Other methods of economic policy, especially fiscal policy may be used to counteract the inflationary pressures by reducing overall effective demand. It may increase the overall flow of resources into investment by restraining consumption and mobilising savings more effectively. This can be done by formulating specific tax measures, evolving proper borrowing techniques and by making economy in public expenditure and also by removing lapses in policy and administration. Deficit financing also, if properly managed and pursued, will not only prove non-inflationary, but also contribute towards attaining a high level of economic activity. If unaccompanied by an adequate growth of real output, deficit financing shall be the worst method of raising resources for development in the economy. It is also to be ensured that the public sector enterprises yield substantial surpluses and act as a helping factor and not as a burden on economic development. In all its aspects, fiscal policy

should aim at generating and mobilising savings to the maximum extent possible and to make provisions for their canalisation into productive investment if the objective of 'growth with stability' is to be achieved.

Black money has certainly been an important factor for the accentuation of inflationary pressures in India. It has raised the foodgrain prices through hoarding and speculative trading by the wholesale dealers and diversion of resources to unauthorised lines. When it is spent on conspicious consumption, it pushes up the prices in certain sectors and extends the effect to other areas as well. The bulk of the black income would accrue as windfall gains, situational and conjunctural rents, partly to the producers, partly to various intermediaries and partly also to those who have the political and economic power or privilege over the distribution of permits, licences, scare commodities, and other rights[1]. A great magnitude of unaccounted money in the country has caused a great loss of revenue to the Government and led to increase the quantum of deficit financing, which in turn, has aggravated the inflationary pressures by raising the rate of increase in money supply. There is, therefore, pressing need to check widespread

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1. C.N. Vakil, et.al., Memorandum On a Policy to Contain Inflation (Bombay : Dr. D.T. Lakdawala, 1974), p. 4.

tendency among certain groups to pile up tremendous hoards of unaccounted money through tax-evasion and other unfair means. The monetary policy is unable to do anything in this regard. It is of paramount importance to use more fiscal and other direct measures than the monetary measures if the growth of black money is to be checked. In recent years, the authorities concerned with the Income Tax Department have fetched a considerable amount of black money in the country by the help of raids. Though the money seized through such raids is negligible in compare to the total black money in the economy. The Voluntary Disclosure Scheme of 1975 has also fetched to the Government an amount of Rs. 232.66 crores out of a total disclosure of Rs. 689 crores of unaccounted money as tax deduction. The Special Bearer Bonds Scheme, which was announced on to mop up black money in the country, is also a wise step in this direction. But, in fact, it has achieved a very little success. Closing the tax loopholes, levying discriminatory excise taxes, using the instrument of taxation effectively to reduce luxury consumption, exempting the increment in savings from income tax, tax-credit schemes based on degrees of utilisation of capacity, raising the tax revenue from agriculture to 3 per cent of net output of agriculture, making search and seizure machinery more rigorous, are some of the measures to be taken to unearth black money from being a great source of menace in the coming years.

Monetary policy cannot alone control the inflationary pressures. Evidently, the role of monetary policy cannot assume the realisation of 'growth with stability'. At best, its role can be only contributory one, however, strategic that role might be. In India, fiscal policy has also a very significant role in the overall economic scene and it carries a large part of the load. In fact, if the battle against inflation is to be won, there must be in any case the closest possible coordination between monetary and fiscal policy. An irresponsible fiscal policy could easily offset the efforts of the monetary authorities to promote economic development with stability. Similarly, a flabby monetary policy would neutralize the efforts of an effective fiscal policy[1]. A 'coordinated monetary-fiscal policy' thus remains probably the most hopeful single weapon that may be used against inflationary pressures in India. Both the policies are to be used in 'mix' or combination. Sometimes monetary and fiscal measures have acted as alternatives and sometimes as complements. In India, in attaining the objective of 'growth with stability', a close coordination between the monetary and fiscal policy is essential[2] while the latter has

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1. Gottfried Haberler, Inflation:Its Causes and Cures (Washington:American Enterprisé Association, 1960), p.71.

2. Alka Agrawal also concludes her study with the following observation: "This leads us to the conclusion that for an effective application of economic policy the two of its major components - fiscal and monetary - must be coordinated with each other." Alka Agrawal, Interdependence of Monetary And Fiscal Policies : A Case Study, p. 282.

to avoid creation of excess purchasing power through Government operations, the former has to regulate the pace of credit creation through banks.

Monetary policy alone, however, essential that may be for price stability, will not suffice to maintain growth without inflationary pressures. In a developing economy like India, inflationary pressures may be generated even in the absence of budget deficits and with relative low rate of investment that may be far from adequate to raise per capita standard of living. There is no single factors which has been responsible for the generation of inflationary pressures in India. While monetary factors have given rise to inflation on the demand side, setback in production particularly agricultural and its improper distribution among the masses have also contributed to accentuate the inflationary pressures on the supply side. It needs to be emphasized, therefore, that in the absence of policies to adapt the pattern of production and supply to the pattern of demand in a growing economy, monetary policy may control inflationary pressures only at the cost of retarding or even preventing economic development. The solution to the problem of inflation does

not lie in taking any one or two isolated measures in a particular direction. If the objective of 'growth with stability' is to be achieved, it encompasses the whole range of techniques of economic policy including monetary policy, fiscal policy, policies for control of expenditure on consumption and investment both in the public and private sectors, policies bearing on control of foreign trade over and above direct physical controls and allocation of production and materials for regulation of prices. Inflation is really a complex problem of the economy as a whole and can be tackled only through a suitable anti-inflationary policy aiming to attack at all fronts of demand and supply conditions in the economic system.

Substantial rise in Government expenditure unaccompanied by an adequate amount of economic growth has accentuated the inflationary pressures during the planning period in India. While, essential expenditure cannot be curtailed and should not be curtailed, every effort should be made for bringing about reduction of all non-essential or non-functional expenditures both in the public and private sectors. We shall have to economise, wherever practicable. There is always justification for eliminating waste, but maintenance of an elaborate machinery for administration shall be indispensable, if we have to sustain economic development with stable conditions. V.K.R.V. Rao's suggestion to setup

a 'National Expenditure Commission'[1] in order to undertake the necessary scrutiny of all expenditure from this point of view and to suggest remedial measures needs to be considered seriously. As regards defence expenditure, sizeable saving is possible without affecting the mobility, fighting power and efficiency of the armed forces.

Economic development is governed by the real factors such as saving and investment. Domestic saving should be raised in confirmity with the targets of investment outlay by methods which do not involve a rise in the price level so as to reduce aggregate demand. The pattern of investment should so framed that the supply of essential of wage goods and raw materials keeps pace with the increased demand for them. Increased aggregate output of both producer and consumer goods can control inflationary pressures and will minimise wage and material costs and will also encourage voluntary savings and enhance the viability of export industries, besides minimising the need for agricultural imports. In other words, every increase in incomes as an essential outcome of increasing investment, should be matched by an increase in total output with a view to meet the demands for consumption and production at reasonably stable prices.

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1. V.K.R.V. Rao, "Price Policy and Economic Development With Special Reference to India", The Economic Weekly, vol. XVI, No. 41, 10 October, 1964.

Efforts should be made to boost up production both industrial as well as agricultural. The industrial production in important sectors like petroleum[1], steel, cement and coal must be given top priority. Agricultural production can be increased by making an extensive use of modern techniques of farming. Increased credit facilities and due price incentives should also be extended to the farmers. Government must, at the same time, improve the distribution system of foodgrains.

One has to require some minimum basic data for the analysis of the determinent factors of inflationary pressure in the absence of which it may become difficult to formulate an appropriate anti-inflationary policy and to sustain the objective of 'growth with stability'. In India, data on money supply and the factors affecting variations therein are deficient in several respects. Since they take into account only currency and demand deposits of the banking system, they are not a true reflection of the pressures of aggregate monetary demand. In view of the feasibility of the shifts from quasi-money assets of the public into its

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1. A special study on global inflation and economic growth of developing countries conducted by the Federations of Indian Chambers of Commerce and Industry indicates that India's requirement of crude may touch the 52 million tonnes mark by 1990. The study points out that if no other oil-wells were discovered between now and 1990, the country could reach of level of 25 million tonnes of output a year which would mean a gap of 27 million tonnes

fn.contd...

monetary assets, it is necessary to include time deposits with the banks and saving deposits with the Post Office Saving Banks also as part of total monetary resources. The available data on saving and investment are also incomplete and have actually large element of guess work in them. Data on trends in real production are also quite an important requirement for the analysis of inflationary situation but here again the data are available after a considerable time-lag. As regards price movement, seasonally adjusted data of the official index number of wholesale prices are not available. The available statistics refer to wholesale prices, whereas in the evaluation of the effect of prices, retail prices (including those of services) are more meaningful. Although delay in collecting and preparing data are inevitable in some degree but certainly there is considerable scope for reducing the present time-lag. Any attempt to analyse fully the factors leading to unstability of prices in the immediate future requires complete data on many more factors which generate such price fluctuations in the economy. Any imperfections or uncertainties in this regard are bound to create difficulties for formulating an appropriate anti-inflationary policy in India.

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between supply and demand. This would generate a huge foreign exchange gap which would place a major economic constraint on developement and stability. <u>Northern India Patrika</u>, 1980, p. 5.

Inflation in India is hydra-headed giant and has become our enemy number one raising its head over and above, and placing great difficulties for achieving the objective of 'growth with stability'. It has retarded than promoted growth. Inflation, if continued, shall lead to near stagnant economic situation. Monetary policy is essential to control inflation and to facilitate the avowed objective of 'growth with stability' but it alone, however, will not suffice to maintain economic growth without inflationary pressures. The solution of the problem lies in the formulation and execution of a suitable anti-inflationary policy through orchestration of various economic policies in the context of India's planning for economic growth. In the absense of such a policy, the country will be faced with the crucial decision of either chocking off economic growth or seeing it frustrated by endurable inflationary pressures.

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APPENDIX-I

Money Supply With the Public

Money supply with the public expanded from Rs.1,966 crores in the year 1950-51 to Rs. 23,268 crores in the year 1980-81. The following table which presents the total money supply statistics, shows that the expansion of money supply has been an uninterrupted affair throughout the period and in some years the expansion was quite sharp and therefore, disturbing.

Total Money Supply With the Public

(Rs. Crores)

Period	Amount	% variation over the year
1950-51	1,966	-
1951-52	1,787	-9
1952-53	1,755	-1
1953-54	1,794	-2
1954-55	1,920	+7
Jan.,1956	2,094	+9
Jan.,1957	2,225	+6
Jan.,1958	2,318	+7
Jan.,1959	2,391	+3
Jan.,1960	2,590	+8
Jan.,1961	2,793	+8

contd...

Period	Amount	% Variation over the year
Jan., 1962	2,925	+5
Jan., 1963	3,180	+9
Jan., 1964	3,645	+15
Jan., 1965	3,976	+9
Jan., 1966	4,363	+10
Jan., 1967	4,745	+9
Jan., 1968	5,116	+8
Jan., 1969	5,500	+8
Jan., 1970	6,155	+11
1970-71	6,387	+40
1971-72	7,140	+11
1972-73	8,138	+12
1973-74	10,848	+33
1974-75	11,527	+6
1975-76	13,172	+14
1976-77	15,650	+18
1977-78	14,388	-8
1978-79	17,229	+19
1979-80	19,947	+15
1980-81	23,268	+11

Source: 'Reserve Bank of India Bulletin', various issues of corresponding years, and 'Report' on Currency and Finance', 1980-81.